FINANCIAL INSTITUTIONS AND EXPORT TRADING COMPANIES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

S. 2718

TO ENCOURAGE EXPORTS BY FACILITATING THE FORMATION AND OPERATION OF EXPORT TRADING COMPANIES, EXPORT TRADE ASSOCIATIONS, AND THE EXPANSION OF EXPORT TRADE SERVICES GENERALLY

JULY 25, 1980

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
66-942 O WASHINGTON : 1980

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WILLIAM PROXMIRE, Wisconsin, *Chairman*

HARRISON A. WILLIAMS, Jr., New Jersey
ALAN CRANSTON, California
ADLAI E. STEVENSON, Illinois
ROBERT MORGAN, North Carolina
DONALD W. RIEGLE, Jr., Michigan
PAUL S. SARBANES, Maryland
DONALD W. STEWART, Alabama
GEORGE J. MITCHELL, Maine

JAKE GARN, Utah
JOHN TOWER, Texas
JOHN HEINZ, Pennsylvania
WILLIAM L. ARMSTRONG, Colorado
NANCY LANDON KASSEBAUM, Kansas
RICHARD G. LUGAR, Indiana

Kenneth A. McLean, *Staff Director*
M. Danny Wall, *Minority Staff Director*
Charles L. Marinaccio, *General Counsel*
Robert W. Russell, *Professional Staff Member*
Paul Freedenberg, *Minority Professional Staff Member*

CONTENTS

FRIDAY, JULY 25, 1980

Additional Material Supplied for the Record

FINANCIAL INSTITUTIONS AND EXPORT TRADING COMPANIES

FRIDAY, JULY 25, 1980

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met, at 9:35 a.m., in room 5302, Dirksen Senate Office Building; Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Stevenson, Garn, and Heinz.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order. Today we have an unusual situation. We are holding hearings on a bill already reported by the committee. We had considerable concern that if we didn't report the bill it couldn't be acted on this year and we recognized it was most desirable to have hearings on this legislation from the banking community and the regulators because it has a profound effect on banking. I think it is so serious that we should give great weight in considering this legislation on the floor to the effect this will have on banking in this country. We will hear from four key witnesses who have not as yet been heard on legislation to permit banks and bank holding companies to take controlling equity positions in export trading companies and to strip the Justice Department Antitrust Division of its authority to administer the antitrust laws dealing with export trade.

Unfortunately, such legislation has already been reported to the floor. In my judgment, if the public interest is to be well served, the legislation must be substantially rewritten.

For over 100 years banking and commerce in this country have been separated. This separation has been the backbone of our economy. Resource concentration and favoritism in the credit granting mechanism are discouraged. A healthy competitive environment has, by and large, been the result. Vigorous enforcement of the antitrust laws against unfair competition and monopoly has reinforced our basic competitive drive.

The export trading company legislation radically alters both the laws separating banking from commerce and the administration of antitrust laws dealing with export trade without any real evidence that the sought for end—increasing exports—will be the result. Indeed the risks are great that substantial harm may be done to the economy by going as far as the current legislation goes.

It seems foolhardy to me to think that our export trade will be significantly enhanced because banks might be permitted to own construction companies to build a textile mill in China, construct an airport in Saudi Arabia or to own commodity trading companies which take a forward position in wheat to sell to the Russians. Banks simply do not have the expertise or the people to undertake such projects. In any event, they should be prohibited from being in such businesses. The risks are too great. Inevitably there will be trouble as in the REIT's and they will have to be bailed out. In the meantime some borrowers will inevitably be favored and worse yet, some would-be borrowers will cater to bank export trading companies in the hope that they will be rewarded as borrowers from banks which own export trading companies.

In Japanese-like fashion, big U.S. banks can be expected to team up with large exporters to reap competitive advantages over smaller institutions.

Let's not kid ourselves. Putting banks in control of export trading companies is not going to solve the balance-of-payments problem or substantially increase exports. There is much to be done to improve our position in the world. We need to streamline our industry, increase productivity, and reduce the burden of Government. We will be wearing blinders if we think the banks—with no expertise to offer—are going to solve our trade problems by taking control of export trading companies that are not limited to engaging in international finance and activities incidental thereto.

One way to increase trade is to balance our competitive position in the world. I have doubts that the amendments to the Webb-Pomerene Act do that. The amendments may encourage the cartelization of our foreign trade by fixing prices and rigging markets overseas and result in higher prices to foreign customers. Will such a result increase trade or merely increase profits to some large exporters at the expense of smaller exporters? Significantly, the legislation gives administrative responsibility to the Commerce Department to enforce the antitrust exemptions for exporters. I do not believe that the public interest is well served by taking administrative responsibility for antitrust enforcement away from the Justice Department where it belongs. I also fear that the amendments will send the wrong signals out to the rest of the world—signals that portend a cartelized economy in U.S. foreign trade. Will price fixing of U.S. exports be appreciated in countries which outlaw price fixing? I doubt it. Our domestic economy and our foreign relations will be better served by leaving administrative enforcement of the antitrust laws to the Justice Department.

I am pleased to welcome Chairman Sprague and Governor Wallich this morning. Before that, however, my colleagues may have a statement they would like to make.

Senator GARN. I have no opening statement this morning.

OPENING STATEMENT OF SENATOR STEVENSON

Senator STEVENSON. Thank you, Mr. Chairman.

Next Tuesday the Commerce Department will announce that in June the United States ran its 50th consecutive monthly trade deficit. The $4 billion deficit in May was the second largest in the Nation's history. The trade deficits mount, adding to inflation and unemployment, weakening the dollar, and our influence in the world. The Government is immobilized. Proposals to reduce export barriers languish, the Export-Import Bank is prohibited from lending more money to exporters this year. Even the stability of the international financial system is jeopardized.

The House of Representatives is refusing to approve the quota increase in the International Monetary Fund. Now the United States failing to compete abroad increasingly finds it can't compete at home, so it is tempted to protect itself from foreign competition. Export trading companies are a small part of the answer to the Nation's competitiveness.

This hearing ought to address the other questions, the large questions on an unfinished national agenda. We should be taking testimony this morning on the National Export Policy Act. We could be examining possibilities for reviving U.S. productivity and innovation. We could be strengthening the world's unstable financial system. Instead we tread as usual a few, small, well-worn circles.

Bank participation in export trading companies has been studied in depth and for a long time by this committee, and by other committees of the Congress. The hearing records are available. The Federal Reserve Board submitted testimony to the International Finance Subcommittee of this committee on April 3, 1980. The committee already knows its position. It also knows that the Comptroller of the Currency, Mr. Heimann, who can't be here this morning, has consistently supported bank participation in export trading companies.

We will hear again this morning that most banks favor this legislation and as it was reported by the committee. The record establishes that the success of trading companies depends upon bank participation. S. 2718 permits that participation but only under the strictest conditions and subject to the approval of appropriate regulatory bodies. It permits bank participation without jeopardizing the condition of the banks. These limitations have been drawn to respond to all of the concerns expressed by witnesses included by our chairman this morning about bank participation.

Among other things, these limitations require the approval of the appropriate regulatory agency before a bank can control a trading company. Ultimately, Mr. Chairman, the condition of banks depends on the condition of our economy. The condition of our economy depends on its competitiveness in a very competitive world. That is what this bill would strengthen.

More than 15 percent of overall U.S. exports are now controlled by Japanese trading companies. Imagine what the United States could do for itself if it tried. I appreciate your concerns, Mr. CHAIRMAN. This bill does break with the past. But I suggest that that is what we had better do, face the future and break with some of our bad habits.

I hope that with this additional record on this subject that the Senate will be permitted to work its will on this bill which promotes growth and employment without inflation. That is all I ask. With this additional record, that the Senate be given a chance to vote it up or down.

Thank you.

The CHAIRMAN. It is obvious the Senate will have that opportunity. The bill was reported by this committee before these hearings were completed and is on the floor and will be called up.

Senator STEVENSON. Mr. Chairman, let me make sure I understand you.

After this hearing, it is your intention to take your hold off the bill?

The CHAIRMAN. No; the hold does not prevent the bill from being called up.

Senator STEVENSON. It does.

The CHAIRMAN. As I understand it, it is to make sure those who put the hold on the legislation would be fully informed in advance and will know when and will have an opportunity to participate in any time limitation, and so forth.

Senator STEVENSON. Then I suggest we meet with the majority leader today. I think he has a different understanding.

The CHAIRMAN. I will be happy to meet with him.

Senator STEVENSON. And work out a time agreement.

The CHAIRMAN. No; I did not say that. I said I will be happy to meet with him and let the Senate work its will. I do not want to be premature.

Senator STEVENSON. What you have now said makes your position very clear. This bill will not be brought up.

Senator GARN. If you would yield, I could put a hold on it because the majority leader always overrides the Republican hold. [Laughter.]

Senator STEVENSON. Maybe he can be persuaded to be bipartisan in this case and overrule a Democratic hold. But we all know that that is what it will take.

The CHAIRMAN. Our first witness this morning is the Honorable Irvine Sprague, Chairman of the Federal Deposit Insurance Corporation. We have a number of witnesses, Mr. Sprague. How long would your oral testimony require?

STATEMENTS OF IRVINE SPRAGUE, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION, AND HENRY C. WALLICH, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. SPRAGUE. I will be brief. I have an extensive statement I would like included in the record.

The CHAIRMAN. That will be done. Ten minutes?

Mr. SPRAGUE. I appreciate your invitation to talk with you today with the full understanding that this is an extraordinary procedure to seek out additional information in a formal hearing after a bill has been reported. I applaud the taking of this action.

We particularly appreciate your request that we suggest any amendments that might, in our opinion, improve the bill you are considering.

First, I would like to apologize for our handling of this matter. Our initial staff response did not reflect consideration by or adoption of policy by our senior staff directors.

This response might have misled the committee. I take full responsibility.

My statement today does reflect our policy. It was discussed and debated with all our 14 regional directors, by the senior staff in Washington, and Director Isaac and I personally participated in many of these sessions. We are in total agreement.

SEPARATION OF BANKING AND COMMERCE

The staff also supports the statement, but admittedly, with some reservations. Our basic position is that we should move cautiously and carefully into this new area, allowing banks to participate in trading companies in many ways, but short of equity control.

The larger question of separating banking and commerce is so serious that we submit it should be addressed head on—directly—before we take this historic step.

Should the move be made prudently, it would give Congress, the banks and the regulators sufficient time to assess the performance and ability of the trading companies and the participating banks. It would allow all of us to make a better judgment as to whether control is either necessary or desirable.

In short, our position is that the role of the bank should be as an investor and lender, but not an owner or operator.

Finally, we recognize that our position is narrowly based. We live day after day with banks in trouble, and we pick up the pieces after they close.

I had hoped to spend all of yesterday in preparation for this hearing. Twice we had interruptions which required the attention of the Board and senior staff to address a fast-moving situation.

Shortly after 8 o'clock this morning, I was in the hallway outside this hearing room with our senior bank supervisory people advising on a course of action they might be required to take this morning.

It is not a major situation. I think we have it under control. I provide you this background to emphasize the fact that the concern of our Corporation may well be prejudiced by our continual exposure to the problems.

We are very sensitive on any action that might conceivably increase these problems. As I said, this may color our judgment, but our judgment is strongly held.

You, of course, have a much broader mandate and a wider perspective and should Congress decide and the President sign legislation that would override our supervisory concern, we will willingly and cheerfully enforce the law in a professional manner.

Thank you.

[The complete statement of Chairman Sprague and a reprint of S. 2718 as reported follows. A copy of Senate Report 96–735 begins on page 289.]

STATEMENT OF

Irvine H. Sprague, Chairman
Federal Deposit Insurance Corporation

Mr. Chairman, I appreciate your invitation to discuss S. 2718, the "Export Trading Company Act of 1980." My remarks are limited to Section 105 of the bill, which provides for banking organization equity investment in export trading companies.

The stated purpose of S. 2718 is "to increase United States exports of products and services by encouraging more efficient provision of export trade services to American producers and suppliers." The bill describes export trading companies as companies principally engaged in the exportation and the facilitation of the exportation of goods and services produced in the United States.

S. 2718 has been reported from your Senate Committee on Banking, Housing and Urban Affairs, has the support of the Administration, and enjoys impressive cosponsorship in the Senate. Within this context of momentum, I am grateful for the opportunity to expand on the concerns over Section 105 which I expressed in writing to the Committee on June 23, and to suggest certain amendments.

We recognize the importance of S. 2718's objective of strengthening the export of United States products and services by encouraging the improvement of export trade services to American producers and suppliers. From our perspective, however, we have questions about the degree and type of bank involvement.

In my June 23 letter, I described the general concerns we have about banking organizations taking any equity position in export trading companies. We recognize, of course, that there are times when compelling national interest requires a change in traditional practices and we should not be forever bound to the past. This may be such a case.

However, we continue to have reservations about those provisions of the bill which would allow a banking organization to acquire ownership control of an export trading company, an innovation that would represent a substantial departure from the long-established separation of banking and commerce in our economic system and could very well have safety and soundness implications.

It is important to recognize that, notwithstanding the priorities which direct us toward altering the environment of banking, such changes are not made without consequence. You have heard other points of view expressing the benefits to be realized by the legislation. It is our responsibility as insurer of the public's deposits to express to you our perception of the potential of added risk to the United States banking system and to highlight the fact that this represents historically significant incursion of banking into the province of commerce.

The concerns I have mentioned have been expressed to you by other bank regulators. Moreover, reservations about the "significant departure in the manner in which our financing institutions have traditionally operated" were expressed by several members of your Committee in its report.

We recognize and applaud the fact that your Committee has made a substantial effort to include safeguards in the legislation in an attempt to meet the supervisory concerns expressed by the Federal Reserve, the Comptroller of the Currency and the FDIC. These safeguards are outlined in detail in a June 18 letter I received from Senator Stevenson. These measures would limit the risk to our banking system, but they would not eliminate it, nor would they overcome the basic conflict inherent in the commingling of banking and commerce.

We, therefore, urge your Committee to move with caution into this new field of banking investment. If you proceed, we suggest that you allow something less than a controlling interest by banking organizations in export trading companies. This would give the banking institutions and the bank regulators time to develop experience and expertise and permit us all to address the question of control from a more knowledgeable position at a later date.

PROVISIONS OF S. 2718

As reported, the bill would allow banks, Edge Act and Agreement Corporations, and bank holding companies -- collectively referred to as "banking organizations" — to invest up to $10 million in one or more export trading companies without regulatory approval if the investment does not amount to control. Proposed investments exceeding the dollar limit or amounting to control would require prior approval of the appropriate Federal regulatory agency.

Our particular concern with this portion of the bill is that it would allow banks to acquire control of export trading companies. If a bank's investment in a company is limited to a 20 percent share, and the bank does not manage the company's operations, there would be substantially less likelihood that a bank would feel legal, business or moral obligations to divert substantial resources to the trading company should it encounter serious financial difficulties.

In reviewing proposals for investment in excess of the discretionary limits, the agency must consider the financial and managerial resources, the competitive situation, and the future prospects of the banking organization and the export trading company concerned. Additionally, however, it must take into account the benefits of the proposal to U.S. business, industrial and agricultural concerns, and the improvement the proposal would bring to the U.S. competitive position in world markets.

We have historically made our decisions about banking practice strictly on the basis of our responsibility for maintaining a safe and sound banking system. S. 2718 would, to a degree, require that we modify our thinking and recognize trade-offs between safe and sound banking and other priorities. No other legislation has ever, to my knowledge, placed us in this position.

S. 2718 also provides that:

- Approval of investment in the trading companies would be denied if the agency finds the probable benefits outweighed by any adverse financial, managerial, competitive or other banking factors, implying that risk is weighed, not on its own characteristics, but in relation to the benefit to be realized by the economy. The agency also may impose conditions it feels will limit a banking organization's financial exposure to an export trading company, or which will prevent conflicts of interest or unsafe or unsound banking practices.

- A limit of up to five percent of a banking organization's consolidated surplus and capital is set for aggregate investment in export trading companies. The limit for Edge Act and Agreement Corporations not engaged in banking is 25 percent. The bill also prohibits the total of a banking organization's historical cost of the direct and indirect investment in and loans to export trading companies from exceeding 10 percent of the organization's capital and surplus.

- Agencies will set standards for the taking of title to goods by any export trading company subsidiary of a banking organization. Advance approval would be required before changes could be made in a trading company's practices in taking title to goods.

S. 2718 would impose the following additional restrictions:

1. The trading company's name may not be similar in any way to that of the investing banking organization.

2. A banking organization may not make loans to any export trading company in which it holds any interest, or to any customers of the company, on terms more favorable than those afforded similar borrowers in similar circumstances, or involving more than normal risks of repayment or displaying other unfavorable features.

3. Banking organizations cannot own any interest in an export trading company which takes positions in commodities or commodities contracts other than as may be necessary in the course of its business operations.

The bill empowers the supervisory agency to order termination of a banking organization's investment in an export trading company whenever: ". . . it has reasonable cause to believe the ownership or control of any investment in an export trading company constitutes a serious risk to the financial safety, soundness, or stability of the banking organization and is inconsistent with sound banking principles or with the purposes of this Act or with the Financial Institutions Supervisory Act of 1966."

In any such case, the bank organization has a right to notice and hearing and ultimate appeal to the courts.

Against this background, I would now like to discuss the concerns I mentioned earlier.

RISKS ASSOCIATED WITH CONTROL

Advocates of bank investment in export trading companies point to the expertise in foreign trade the banks could bring to such companies. We are not convinced that banks — other than a few money center or major regional banks -- have any particular expertise in foreign markets.

Under the proposed bill, banking organizations would be allowed to acquire control of export trading companies which could engage in a virtually unlimited range of activities and assume commercial risks unsuited to banks. For example, under the bill, the companies could own and deal in commodities, and could acquire shipping companies and warehouses. There is potentially a high degree of risk associated with these and other activities in which export trading companies may engage.

A bank controlling a foundering trading company may incur legal liability if, for example, the bank provides management or engages in significant intercompany transactions.

Perhaps of greater importance than the legal considerations, a bank might be under considerable pressure to come to the aid of a troubled export trading company it has sponsored. History offers many examples of banks and other companies that have come to the aid of troubled subsidiaries in order to protect the parent company's reputation in the business community.

Recent experiences in connection with bank-sponsored Real Estate Investment Trusts (REITs) are illustrative of the legal and practical business obligations banks feel toward undertakings they sponsor. Some banks provided assistance due to legal considerations stemming from interlocking officers and directors and the provision of advisory services. Others came to the aid of the sponsored REITs because they believed failure to do so would severely damage their bank's reputation in its community and in business and financial circles generally.

Whatever the motivation for the assistance, the exposure may be substantially greater than the bank's equity investment due to leveraging and the potential for off-balance sheet losses.

SEPARATION OF BANKING AND COMMERCE

The separation of banking and commerce has served us well throughout our history. This separation was and is occasioned by concern for the safety and soundness of banks, fear of undue concentration of economic power, the necessity of preventing unfair competition, and the desire to guard against possible conflicts of interest between a bank's responsibility to its depositors and its own economic interests arising from ownership of nonbanking firms.

These concerns were articulated in a House Report on the 1956 amendments to the Bank Holding Company Act dealing with the divestiture of nonbanking business by bank holding companies (H.R. Report No. 609, 84th Congress, 1st Session 16 (1955)). The Report warned of the danger to depositors that might result where the bank finds itself in effect both the borrower and the lender.

The Report continued:

> "Whenever a holding company thus controls both banks and nonbanking business, it is apparent that the holding company's nonbanking business may thereby occupy a preferred position over that of its competitors in obtaining bank credit. It is also apparent that in critical times the holding company which operates nonbanking businesses may be subjected to strong temptation to cause the banks which it controls to make loans to its nonbanking affiliates even though such loans may not at that time be entirely justified in the light of current banking standards. In either situation the public interest becomes directly involved."

These considerations appear to us to be applicable as well to the relationships that would exist under S. 2718 between banks and export trading companies.

We are concerned that the protective measures built into S. 2718 might not be sufficient to prevent abusive practices. For example, if a bank were to make credit available to an affiliated company but not to a similarly situated non-affiliated company, it might not be in violation of the bill's preferential lending restrictions. In short, the restriction only applies to credit extensions on more favorable terms, and not to credit availability. The FDIC believes the potential for conflicts of this type must be minimized.

PREEMPTION OF STATE AUTHORITY

Section 105(b)(1) of S. 2718 provides for the investment in voting stock or other evidence of ownership of one or more export trading companies by any banking organization "Notwithstanding any prohibition, restriction, limitation, condition or requirement of any other law . . . ." The effect of this language is to preempt those State banking laws which prescribe the powers of the banks chartered under those laws.

Although Federal law has in the past provided restrictions on investments by State banks, such as those imposed on investments in affiliates prescribed by Section 23A of the Federal Reserve Act and Section 18(j) of the Federal Deposit Insurance Act, it is a fundamentally different matter to expand the investment powers of State banks beyond the powers granted them by the laws under which they are incorporated.

FDIC suggests that Section 105(b)(1) be revised to provide that the bill not preempt applicable State laws governing investment powers of banks. This would conform to the policy adopted by the Congress in legislation pertaining to banking investment in Edge Corporations and Small Business Investment Companies.

PRESSURE ON CAPITAL RATIOS

S. 2718 recognizes that permitting investment by banks in export trading companies poses safety and soundness questions, and it would limit the size of such investments both in terms of the total dollar amount and as a percentage of capital. Nonetheless, the risk exposure of banking organizations undoubtedly would increase if they are granted such investment powers.

This potential is greatest for the largest institutions — the regional and money center banks — which are the most likely to engage in this kind of investment activity. As we reported to the Committee in our testimony of May 21, 1980, on the condition of the banking system, the ratio of equity capital to total assets among the Nation's 300 largest banks declined in 1979 for the third straight year. The ratio for banks having assets of $5 billion or more declined last year to 4.0 percent, compared to a ratio more than twice as great for our smallest banks. Moreover, with the substantially increased loan volume produced by a growing economy, risks supported by these declining ratios have increased considerably over the past two decades.

Investments in export trading companies could represent riskier assets than most of the loans and investments comprising bank asset portfolios. Such investments would necessarily mean that a banking organization's equity base would have to support a greater degree of overall risk.

Your Committee recognized the capital problem and devoted 25 lines on page 11 of your Report to this issue, concluding it did not represent a serious problem, since you project only $1 billion in total bank investments and loans over the initial five year period.

Our conclusion was different. Although the incremental erosion in capital ratios for the largest institutions would be modest, we can't be happy about any development which would exacerbate their declining ratios.

ADDITIONAL AMENDMENTS

As I noted, Section 105 would authorize banking organizations to control export trading companies, subject to the approval of the appropriate Federal banking agency. Recognizing a need for caution, we support the recommendations of Chairman Volcker of the Federal Reserve, who wrote on May 12, 1980, that "it would not be prudent to permit banking organizations to exercise control over export trading companies at this time." We strongly urge that Section 105 be amended to include a provision that no banking organization, alone or in concert with its affiliates, be permitted to acquire more than 20 percent of the voting stock of an export trading company or to control the company in any other way, and that not more than 50 percent of an export trading company's voting stock be owned by any group of banking organizations.

The rationale for these recommendations is to give the banking industry and the bank regulators an opportunity to gain experience and develop a measurable track record before a final determination is made as to whether banking organizations should be permitted to control export trading companies. During this period, banking organizations also could test the expanded export trade services offered by last year's amendments to the Edge Corporation rules and the Federal Reserve could consider additional liberalizations in this area.

Governor Wallich in his statement of April 3, 1980, described existing export services through Edge Corporations as encompassing a full range of financing services, foreign exchange facilities, information on foreign markets and economies, introductions, business references, and advice on arranging shipments. Amendments to the Edge Corporation rules, effective June 14, 1979, expanded the finance capabilities of Edge Corporations in the international export trade area and permitted them to branch domestically, thus potentially increasing access to their services.

-- We urge that the bill be amended to require that any investment by a banking organization in an export trading company, regardless of amount, be subject to prior approval by the appropriate Federal banking agency.

— Section 103(a)(5) of the bill defines an export trading company as a company organized and operated "principally" to export U.S. goods and services and to facilitate their exportation by unaffiliated persons. Notwithstanding the discussion of this point in the Senate Committee Report, the word "principally" is somewhat ambiguous and provides an avenue for export trading companies to become significantly engaged in activities or operations that are not at all related to the conduct of an export trading company.

To the extent that trading companies are permitted to engage in unrelated activities, the purpose of the bill could be defeated and the risk of loss increased. We believe that the definition of export trading company should be more clearly defined and made more restrictive. We suggest that the definition limit the operation and activities of such companies to the business of exporting U.S. goods and services and the facilitation of their export by unaffiliated persons, and to activities so closely related to that business as to be a proper incident thereto.

— We are also concerned that the definition of "capital and surplus" in Section 105(a)(10) could be interpreted to include subordinated notes and debentures. We suggest that the bill or its legislative history make clear that this is not the case.

— Sections 105(b)(2) and (3) would require the appropriate banking agency to act within 60 days on written notice by banking organizations of their intentions to make additional investments or to undertake certain activities by export trading companies and to act within 90 days of notice by a banking organization of its intent to make a $10 million investment or any controlling investment in an export trading company. If the agency fails to act within the time limits, the application would be deemed approved. If our recommendations on control and prior approval of all investments are not accepted, we recommend that — in both instances -- the statutory limit be extended to 120 days or that the agency be authorized to make appropriate extensions, provided that the total waiting period does not exceed 120 days.

— Section 105(c)(3) precludes export trading companies from taking positions in commodities or commodity contracts "other than as may be necessary in the course of its business operations." The intent is to prevent speculation in commodities. We believe the section should be amended to preclude speculation in foreign exchange and securities as well.

-- Section 105(d)(2) gives Federal banking agencies 270 days after enactment to establish standards for taking title to goods and holding inventory to prevent unsafe and unsound practices. In view of the newness and complexity of the issue, we believe 270 days is insufficient and recommend the time limit be at least one year.

CONCLUSION

We appreciate the opportunity to comment on this bill. Should you be inclined to accept any of our suggestions we would be glad to provide drafting assistance by our staff.

Calendar No. 785

96TH CONGRESS
2D SESSION

S. 2718

[Report No. 96–735]

To encourage exports by facilitating the formation and operation of export trading companies, export trade associations, and the expansion of export trade services generally.

IN THE SENATE OF THE UNITED STATES

MAY 15 (legislative day, JANUARY 3), 1980

Mr. STEVENSON, from the Committee on Banking, Housing, and Urban Affairs, reported the following bill; which was read twice and ordered to be placed on the calendar

---

A BILL

To encourage exports by facilitating the formation and operation of export trading companies, export trade associations, and the expansion of export trade services generally.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I—EXPORT TRADING COMPANIES

SHORT TITLE

SEC. 101. This title may be cited as the "Export Trading Company Act of 1980".

FINDINGS

SEC. 102. (a) The Congress finds and declares that—

(1) tens of thousands of American companies produce exportable goods or services but do not engage in exporting;

(2) although the United States is the world's leading agricultural exporting nation, many farm products are not marketed as widely and effectively abroad as they could be through producer-owned export trading companies;

(3) exporting requires extensive specialized knowledge and skills and entails additional, unfamiliar risks which present costs for which smaller producers cannot realize economies of scale;

(4) export trade intermediaries, such as trading companies, can achieve economies of scale and acquire expertise enabling them to export goods and services profitably, at low per unit cost to producers;

(5) the United States lacks well-developed export trade intermediaries to package export trade services at reasonable prices (exporting services are fragmented

into a multitude of separate functions; companies attempting to offer comprehensive export trade services lack financial leverage to reach a significant portion of potential United States exporters);

(6) State and local government activities which initiate, facilitate, or expand export of products and services are an important and irreplaceable source for expansion of total United States exports, as well as for experimentation in the development of innovative export programs keyed to local, State, and regional economic needs;

(7) the development of export trading companies in the United States has been hampered by insular business attitudes and by Government regulations; and

(8) if United States export trading companies are to be successful in promoting United States exports and in competing with foreign trading companies, they must be able to draw on the resources, expertise, and knowledge of the United States banking system, both in the United States and abroad.

(b) The purpose of this Act is to increase United States exports of products and services by encouraging more efficient provision of export trade services to American producers and suppliers.

DEFINITIONS

SEC. 103. (a) As used in this Act—

(1) the term "export trade" means trade or commerce in goods sourced in the United States or services produced in the United States exported, or in the course of being exported, from the United States to any foreign nation;

(2) the term "goods produced in the United States" means tangible property manufactured, produced, grown, or extracted in the United States, the cost of the imported raw materials and components thereof shall not exceed 50 per centum of the sales price;

(3) the term "services produced in the United States" includes, but is not limited to accounting, amusement, architectural, automatic data processing, business, communications, construction franchising and licensing, consulting, engineering, financial, insurance, legal, management, repair, tourism, training, and transportation services, not less than 50 per centum of the sales or billings of which is provided by United States citizens or is otherwise attributable to the United States;

(4) the term "export trade services" includes, but is not limited to, consulting, international market re-

search, advertising, marketing, insurance, product research and design, legal assistance, transportation, including trade documentation and freight forwarding, communication and processing of foreign orders to and for exporters and foreign purchasers, warehousing, foreign exchange, and financing when provided in order to facilitate the export of goods or services produced in the United States;

(5) the term "export trading company" means a company which does business under the laws of the United States or any State and which is organized and operated principally for the purposes of—

(A) exporting goods or services produced in the United States; and

(B) facilitating the exportation of goods and services produced in the United States by unaffiliated persons by providing one or more export trade services;

(6) the term "United States" means the several States of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands;

(7) the term "Secretary" means the Secretary of Commerce; and

(8) the term "company" means any corporation, partnership, association, or similar organization.

(b) The Secretary is authorized, by regulation, to further define such terms consistent with this section.

FUNCTIONS OF THE SECRETARY OF COMMERCE

SEC. 104. The Secretary shall promote and encourage the formation and operation of export trading companies by providing information and advice to interested persons and by facilitating contact between producers of exportable goods and services and firms offering export trade services.

OWNERSHIP OF EXPORT TRADING COMPANIES BY BANKS, BANK HOLDING COMPANIES, AND INTERNATIONAL BANKING CORPORATIONS

SEC. 105. (a) For the purpose of this section—

(1) the term "banking organization" means any State bank, national bank, Federal savings bank, bankers' bank, bank holding company, Edge Act Corporation, or Agreement Corporation;

(2) the term "State bank" means any bank which is incorporated under the laws of any State, any territory of the United States, the Commonwealth of Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, or the Virgin

Islands, or any bank (except a national bank) which is operating under the Code of Law for the District of Columbia (hereinafter referred to as a "District bank");

(3) the term "State member bank" means any State bank, including a bankers' bank, which is a member of the Federal Reserve System;

(4) the term "State nonmember insured bank" means any State bank, including a bankers' bank, which is not a member of the Federal Reserve System, but the deposits of which are insured by the Federal Deposit Insurance Corporation;

(5) the term "bankers' bank" means any bank which (A) is organized solely to do business with other financial institutions, (B) is owned primarily by the financial institutions with which it does business, and (C) does not do business with the general public;

(6) the term "bank holding company" has the same meaning as in the Bank Holding Company Act of 1956;

(7) the term "Edge Act Corporation" means a corporation organized under section 25(a) of the Federal Reserve Act;

(8) the term "Agreement Corporation" means a corporation operating subject to section 25 of the Federal Reserve Act;

(9) the term "appropriate Federal banking agency" means—

(A) the Comptroller of the Currency with respect to a national bank or any District bank;

(B) the Board of Governors of the Federal Reserve System with respect to a State member bank, bank holding company, Edge Act Corporation, or Agreement Corporation;

(C) the Federal Deposit Insurance Corporation with respect to a State nonmember insured bank except a District bank; and

(D) the Federal Home Loan Bank Board with respect to a Federal savings bank.

In any situation where the banking organization holding or making an investment in an export trading company is a subsidiary of another banking organization which is subject to the jurisdiction of another agency, and some form of agency approval or notification is required, such approval or notification need only be obtained from or made to, as the case may be, the appropriate Federal banking agency for the banking organization making or holding the investment in the export trading company;

(10) the term "capital and surplus" means paid in and unimpaired capital and surplus, and includes un-

divided profits and such other items as the appropriate Federal banking agency may deem appropriate;

(11) an "affiliate" of a banking organization or export trading company is a person who controls, is controlled by, or is under common control with such banking organization or export trading company;

(12) the terms "control" and "subsidiary" shall have the same meanings assigned to those terms in section 2 of the Bank Holding Company Act of 1956, and the terms "controlled" and "controlling" shall be construed consistently with the term "control" as defined in section 2 of the Bank Holding Company Act of 1956; and

(13) the term "export trading company" has the same meaning as in section 103(5) of this Act, or means any company organized and operating principally for the purpose of providing export trade services, as defined in section 103(4) of this Act.

(b)(1) Notwithstanding any prohibition, restriction, limitation, condition, or requirement of any other law, a banking organization, subject to the limitations of subsection (c) and the procedures of this subsection, may invest directly and indirectly in the aggregate, up to 5 per centum of its consolidated capital and surplus (25 per centum in the case of an Edge Act Corporation or Agreement Corporation not engaged in banking) in the voting stock or other evidences of ownership of one or more export trading companies. A banking organization may—

(A) invest up to an aggregate amount of $10,000,000 in one or more export trading companies without the prior approval of the appropriate Federal banking agency, if such investment does not cause an export trading company to become a subsidiary of the investing banking organization; and

(B) make investments in excess of an aggregate amount of $10,000,000 in one or more export trading companies, or make any investment or take any other action which causes an export trading company to become a subsidiary of the investing banking organization or which will cause more than 50 per centum of the voting stock of an export trading company to be owned or controlled by banking organizations, only with the prior approval of the appropriate Federal banking agency.

Any banking organization which makes an investment under authority of clause (A) of the preceding sentence shall promptly notify the appropriate Federal banking agency of such investment and shall file such reports on such investment as such agency may require. If, after receipt of any such notification, the appropriate Federal banking agency determines, after notice and opportunity for hearing, that the export trading company is a subsidiary of the investing banking organization, it shall have authority to disapprove the investment or impose conditions on such investment under authority of subsection (d). In furtherance of such authority, the appropriate Federal banking agency may require divestiture of any voting stock or other evidences of ownership previously acquired, and may impose conditions necessary for the termination of any controlling relationship.

(2) If a banking organization proposes to make any investment or engage in any activity included within the following two subparagraphs, it must give the appropriate Federal banking agency sixty days prior written notice before it makes such investment or engages in such activity:

(A) any additional investment in an export trading company subsidiary; or

(B) the engagement by any export trading company subsidiary in any line of activity, including specifically the taking of title to goods, wares, merchandise, or commodities, if such activity was not disclosed in any prior application for approval.

During the notification period provided under this paragraph, the appropriate Federal banking agency may, by written notice, disapprove the proposed investment or activity or impose conditions on such investment or activity under authority of subsection (d). An additional investment or activity covered by this paragraph may be made or engaged in, as the case may be, prior to the expiration of the notification period if the appropriate Federal banking agency issues written notice of its intent not to disapprove.

(3) In the event of the failure of the appropriate Federal banking agency to act on any application for approval under paragraph (1)(B) of this subsection within the ninety-day period which begins on the date the application has been accepted for processing by the appropriate Federal banking agency, the application shall be deemed to have been granted. In the event of the failure of the appropriate Federal banking agency either to disapprove or to impose conditions on any investment or activity subject to the prior notification requirements of paragraph (2) of this subsection within the sixty-day period provided therein, such period beginning on the date the notification has been received by the appropriate Federal banking agency, such investment or activity may be made or engaged in, as the case may be, any time after the expiration of such period.

(c) The following limitations apply to export trading companies and the investments in such companies by banking organizations:

(1) The name of any export trading company shall not be similar in any respect to that of a banking orga-

nization that owns any of its voting stock or other evidences of ownership.

(2) The total historical cost of the direct and indirect investments by a banking organization in an export trading company combined with extensions of credit by the banking organization and its direct and indirect subsidiaries to such export trading company shall not exceed 10 per centum of the banking organization's capital and surplus.

(3) A banking organization that owns any voting stock or other evidences of ownership of an export trading company shall terminate its ownership of such stock if the export trading company takes positions in commodities or commodities contracts other than as may be necessary in the course of its business operations.

(4) No banking organization holding voting stock or other evidences of ownership of any export trading company may extend credit or cause any affiliate to extend credit to any export trading company or to customers of such company on terms more favorable than those afforded similar borrowers in similar circumstances, and such extension of credit shall not involve more than the normal risk of repayment or present other unfavorable features.

(d)(1) In the case of every application under subsection (b)(1)(B) of this section, the appropriate Federal banking agency shall take into consideration the financial and managerial resources, competitive situation, and future prospects of the banking organization and export trading company concerned, and the benefits of the proposal to United States business, industrial, and agricultural concerns, and to improving United States competitiveness in world markets. The appropriate Federal banking agency may not approve any investment for which an application has been filed under subsection (b)(1)(B) if it finds that the export benefits of such proposal are outweighed in the public interest by any adverse financial, managerial, competitive, or other banking factors associated with the particular investment. Any disapproval order issued under this section must contain a statement of the reasons for disapproval.

(2) In approving any application submitted under subsection (b)(1)(B), the appropriate Federal banking agency may impose such conditions which, under the circumstances of such case, it may deem necessary (A) to limit a banking organization's financial exposure to an export trading company, or (B) to prevent possible conflicts of interest or unsafe or unsound banking practices. With respect to the taking of title to goods, wares, merchandise, or commodities by any export trading company subsidiary of a banking organization, the

appropriate Federal banking agencies shall establish standards designed to ensure against any unsafe or unsound practices that could adversely affect a controlling banking organization investor, including specifically practices pertaining to an export trading company subsidiary's holding of title to inventory. Such standards should be established no later than two hundred and seventy days after enactment of this Act, and opportunity should be provided for public comment and participation in developing such standards. If an export trading company subsidiary of a banking organization proposes to take title to goods, wares, merchandise, or commodities in a manner which does not conform to such standards, or prior to the establishment of such standards, it may only do so with the prior approval of the appropriate Federal banking agency and subject to such conditions and limitations as it may impose under this paragraph.

(3) In determining whether to impose any condition under the preceding paragraph (2), or in imposing such condition, the appropriate Federal banking agency must give due consideration to the size of the banking organization and export trading company involved, the degree of investment and other support to be provided by the banking organization to the export trading company, and the identity, character, and financial strength of any other investors in the export trading company. The appropriate Federal banking agency

shall not impose any conditions or set standards for the taking of title which unnecessarily disadvantage, restrict or limit export trading companies in competing in world markets or in achieving the purposes of section 102 of this Act. In particular, in setting standards for the taking of title under the preceding paragraph (2), the appropriate Federal banking agencies shall give special weight to the need to take title in certain kinds of trade transactions, such as international barter transactions.

(4) Notwithstanding any other provision of this Act, the appropriate Federal banking agency may, whenever it has reasonable cause to believe that the ownership or control of any investment in an export trading company constitutes a serious risk to the financial safety, soundness, or stability of the banking organization and is inconsistent with sound banking principles or with the purposes of this Act or with the Financial Institutions Supervisory Act of 1966, order the banking organization, after due notice and opportunity for hearing, to terminate (within one hundred and twenty days or such longer period as the Board may direct in unusual circumstances) its investment in the export trading company.

(5) On or before two years after enactment of this Act, the appropriate Federal banking agencies shall jointly report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and

Urban Affairs of the House of Representatives their recommendations with respect to the implementation of this section, their recommendations on any changes in United States law to facilitate the financing of United States exports, especially by smaller and medium-sized business concerns, and their recommendations on the effects of ownership of United States banks by foreign banking organizations affiliated with trading companies doing business in the United States.

(e)(1) Any party aggrieved by an order of an appropriate Federal banking agency under this section may obtain a review of such order in the United States court of appeals within any circuit wherein such organization has its principal place of business, or in the court of appeals for the District of Columbia Circuit, by filing a notice of appeal in such court within thirty days from the date of such order, and simultaneously sending a copy of such notice by registered or certified mail to the appropriate Federal banking agency. The appropriate Federal banking agency shall promptly certify and file in such court the record upon which the order was based. The court shall set aside any order found to be (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; (B) contrary to constitutional right, power, privilege or immunity; or, (C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; or (D) without observance of procedure required by law. Except for violations of subsection (b)(3) of this section, the court shall remand for further consideration by the appropriate Federal banking agency any order set aside solely for procedural errors and may remand for further consideration by the appropriate Federal banking agency any order set aside for substantive errors. Upon remand, the appropriate Federal banking agency shall have no more than sixty days from date of issuance of the court's order to cure any procedural error or reconsider its prior order. If the agency fails to act within this period, the application or other matter subject to review shall be deemed to have been granted as a matter of law.

(f)(1) The appropriate Federal banking agencies are authorized and empowered to issue such rules, regulations, and orders, to require such reports, to delegate such functions, and to conduct such examinations of subsidiary export trading companies, as each of them may deem necessary in order to perform their respective duties and functions under this section and to administer and carry out the provisions and purposes of this section and prevent evasions thereof.

(2) In addition to any powers, remedies, or sanctions otherwise provided by law, compliance with the requirements imposed under this section may be enforced under section 8 of the Federal Deposit Insurance Act by any appropriate Federal banking agency defined in that Act.

INITIAL INVESTMENTS AND OPERATING EXPENSES

SEC. 106. (a) The Economic Development Administration and the Small Business Administration are directed, in their consideration of applications by export trading companies for loans and guarantees, including applications to make new investments related to the export of goods or services produced in the United States and to meet operating expenses, to give special weight to export-related benefits, including opening new markets for United States goods and services abroad and encouraging the involvement of small or medium-size businesses or agricultural concerns in the export market.

(b) There are authorized to be appropriated as necessary to meet the purposes of this section, $20,000,000 for each fiscal year, 1981, 1982, 1983, 1984, and 1985. Amounts appropriated pursuant to the authority of this subsection shall be in addition to amounts appropriated under the authority of other Acts.

GUARANTEES FOR EXPORT ACCOUNTS RECEIVABLE AND INVENTORY

SEC. 107. The Export-Import Bank of the United States is authorized and directed to establish a program to provide guarantees for loans extended by financial institutions or other private creditors to export trading companies as defined in section 103(5) of this Act, or to other exporters, when such loans are secured by export accounts receivable or inventories of exportable goods, and when in the judgment of the Board of Directors—

(1) the private credit market is not providing adequate financing to enable otherwise creditworthy export trading companies or exporters to consummate export transactions; and

(2) such guarantees would facilitate expansion of exports which would not otherwise occur.

Guarantees provided under the authority of this section shall be subject to limitations contained in annual appropriations Acts.

TITLE II—EXPORT TRADE ASSOCIATIONS

SHORT TITLE

SEC. 201. This title may be cited as the "Export Trade Association Act of 1980".

FINDINGS; DECLARATION OF PURPOSE

SEC. 202. (a) FINDINGS.—The Congress finds and declares that—

(1) the exports of the American economy are responsible for creating and maintaining one out of every nine manufacturing jobs in the United States and for generating one out of every $7 of total United States goods produced;

(2) exports will play an even larger role in the United States economy in the future in the face of severe competition from foreign government-owned and subsidized commercial entities;

(3) between 1968 and 1977 the United States share of total world exports fell from 19 per centum to 13 per centum;

(4) trade deficits contribute to the decline of the dollar on international currency markets, fueling inflation at home;

(5) service-related industries are vital to the well-being of the American economy inasmuch as they create jobs for seven out of every ten Americans, provide 65 per centum of the Nation's gross national product, and represent a small but rapidly rising percentage of United States international trade;

(6) small and medium-sized firms are prime beneficiaries of joint exporting, through pooling of technical expertise, help in achieving economies of scale, and assistance in competing effectively in foreign markets; and

(7) the Department of Commerce has as one of its responsibilities the development and promotion of United States exports.

(b) PURPOSE.—It is the purpose of this Act to encourage American exports by establishing an office within the Department of Commerce to encourage and promote the formation of export trade associations through the Webb-Pomerene Act, by making the provisions of that Act explicitly applicable to the exportation of services, and by transferring the responsibility for administering that Act from the Federal Trade Commission to the Secretary of Commerce.

DEFINITIONS

SEC. 203. The Webb-Pomerene Act (15 U.S.C. 61–66) is amended by striking out the first section (15 U.S.C. 61) and inserting in lieu thereof the following:

"SECTION 1. DEFINITIONS.

"As used in this Act—

"(1) EXPORT TRADE.—The term 'export trade' means trade or commerce in goods, wares, merchandise, or services exported, or in the course of being exported from the United States or any territory thereof to any foreign nation.

"(2) SERVICE.—The term 'service' means intangible economic output, including, but not limited to—

"(A) business, repair, and amusement services;

"(B) management, legal, engineering, architectural, and other professional services; and

"(C) financial, insurance, transportation, and communication services.

"(3) EXPORT TRADE ACTIVITIES.—The term 'export trade activities' includes activities or agreements in the course of export trade.

"(4) TRADE WITHIN THE UNITED STATES.—The term 'trade within the United States' whenever used in this Act means trade or commerce among the several States or in any territory of the United States, or in the District of Columbia, or between any such territory and another, or between any such territory or territories and any State or States or the District of Columbia, or between the District of Columbia and any State or States.

"(5) ASSOCIATION.—The term 'association' means any combination, by contract or other arrangement, of persons who are citizens of the United States, partnerships which are created under and exist pursuant to the laws of any State or of the United States, or corporations which are created under and exist pursuant to the laws of any State or of the United States.

"(6) EXPORT TRADING COMPANY.—The term 'export trading company' means an export trading company as defined in section 103(5) of the Export Trading Company Act of 1980.

"(7) ANTITRUST LAWS.—The term 'antitrust laws' means the antitrust laws defined in the first section of the Clayton Act (15 U.S.C. 12) and section 4 of the Federal Trade Commission Act (15 U.S.C. 44), and any State antitrust or unfair competition law.

"(8) SECRETARY.—The term 'Secretary' means the Secretary of Commerce.

"(9) ATTORNEY GENERAL.—The term 'Attorney General' means the Attorney General of the United States.

"(10) COMMISSION.—The term 'Commission' means the Federal Trade Commission.".

ANTITRUST EXEMPTION

SEC. 204. The Webb-Pomerene Act (15 U.S.C. 61–66) is amended by striking out section 2 (15 U.S.C. 62) and inserting in lieu thereof the following:

"SEC. 2. EXEMPTION FROM ANTITRUST LAWS.

"(a) ELIGIBILITY.—The export trade, export trade activities, and methods of operation of any association, entered into for the sole purpose of engaging in export trade, and engaged in or proposed to be engaged in such export trade, and the export trade and methods of operation of any export trading company, that—

"(1) serve to preserve or promote export trade;

"(2) result in neither a substantial lessening of competition or restraint of trade within the United States nor a substantial restraint of the export trade of any competitor of such association;

"(3) do not unreasonably enhance, stabilize, or depress prices within the United States of the goods, wares, merchandise, or services of the class exported by such association;

"(4) do not constitute unfair methods of competition against competitors engaged in the export trade of goods, wares, merchandise, or services of the class exported by such association;

"(5) do not include any act which results, or may reasonably be expected to result, in the sale for consumption or resale within the United States of the goods, wares, merchandise, or services exported by the association or export trading company or its members; and

"(6) do not constitute trade or commerce in the licensing of patents, technology, trademarks, or know-how, except as incidental to the sale of the goods, wares, merchandise, or services exported by the association or export trading company or its members shall, when certified according to the procedures set forth in this Act, be eligible for the exemption provided in subsection (b).

"(b) EXEMPTION.—An association or an export trading company and its members with respect to its export trade, export trade activities and methods of operation are exempt from the operation of the antitrust laws as relates to their respective export trade, export trade activities or methods of operation that are specified in a certificate issued according to the procedures set forth in the Act, carried out in conformity with the provisions, terms, and conditions prescribed in such certificate and engaged in during the period in which such certificate is in effect. The subsequent revocation or invalidation of such certificate shall not render the association or its members or an export trading company or its members, liable under the antitrust laws for such trade, export trade activities, or methods of operation engaged in during such period.

"(c) DISAGREEMENT OF ATTORNEY GENERAL OR COMMISSION.—Whenever, pursuant to section 4(b)(1) of this Act, the Attorney General or Commission has formally advised the Secretary of disagreement with his determination to issue a proposed certificate, and the Secretary has nonetheless issued such proposed certificate or an amended certificate, the exemption provided by this section shall not be effective until thirty days after the issuance of such certificate.".

AMENDMENT OF SECTION 3

SEC. 205. (a) CONFORMING CHANGES IN STYLE.—The Webb-Pomerene Act (15 U.S.C. 61–66) is amended—

(1) by inserting immediately before section 3 (15 U.S.C. 63) the following:

"SEC. 3. OWNERSHIP INTEREST IN OTHER TRADE ASSOCIATIONS PERMITTED.",

(2) by striking out "SEC. 3. That nothing" in section 3 and inserting in lieu thereof "Nothing".

ADMINISTRATION: ENFORCEMENT: REPORTS

SEC. 206. (a) IN GENERAL.—The Webb-Pomerene Act (15 U.S.C. 61–66) is amended by striking out sections 4 and 5 (15 U.S.C. 64 and 65) and inserting in lieu thereof the following sections:

"SEC. 4. CERTIFICATION.

"(a) PROCEDURE FOR APPLICATION.—Any association, company, or export trading company seeking certification under this Act shall file with the Secretary a written application for certification setting forth the following:

"(1) The name of the association or export trading company.

"(2) The location of all of the offices or places of business of the association or export trading company in the United States and abroad.

"(3) The names and addresses of all of the officers, stockholders, and members of the association or export trading company.

"(4) A copy of the certificate or articles of incorporation and bylaws, if the association or export trading company is a corporation; or a copy of the articles, partnership, joint venture, or other agreement or contract under which the association conducts or proposes to conduct its export trade activities or contract of association, if the association is unincorporated.

"(5) A description of the goods, wares, merchandise, or services which the association or export trading company or their members export or propose to export.

"(6) A description of the domestic and international conditions, circumstances, and factors which show that the association or export trading company and its activities will serve a specified need in promoting the export trade of the described goods, wares, merchandise, or services.

"(7) The export trade activities in which the association or export trading company intends to engage

56-942 O - 80 - 4

and the methods by which the association or export trading company conducts or proposes to conduct export trade in the described goods, wares, merchandise, or services, including, but not limited to, any agreements to sell exclusively to or through the association, any agreements with foreign persons who may act as joint selling agents, any agreements to acquire a foreign selling agent, any agreements for pooling tangible or intangible property or resources, or any territorial, price-maintenance, membership, or other restrictions to be imposed upon members of the association or export trading company.

"(8) The names of all countries where export trade in the described goods, wares, merchandise, or services is conducted or proposed to be conducted by or through the association or export trading company.

"(9) Any other information which the Secretary may request concerning the organization, operation, management, or finances of the association or export trading company; the relation of the association or export trading company to other associations, corporations, partnerships, and individuals; and competition or potential competition, and effects of the association or export trading company thereon. The Secretary may request such information as part of an initial application or as a necessary supplement thereto. The Secretary may not request information under this paragraph which is not reasonably available to the person making application or which is not necessary for certification of the prospective association or export trading company.

"(b) ISSUANCE OF CERTIFICATE.—

"(1) NINETY-DAY PERIOD.—The Secretary shall issue a certificate to an association or export trading company within ninety days after receiving the application for certification or necessary supplement thereto if the Secretary, after consultation with the Attorney General and Commission, determines that the association, its export trade, export trade activities and methods of operation, or export trading company, and its export trade, export trade activities and methods of operation meet the requirements of section 2 of this Act and that the association or export trading company and its activities will serve a specified need in promoting the export trade of the goods, wares, merchandise, or services described in the application for certification. The certificate shall specify the permissible export trade, export trade activities and methods of operation of the association or export trading company and shall include any terms and conditions the Secretary deems necessary to comply with the requirements of section 2 of this Act. The Secretary shall deliver to the Attorney General and the Commission a copy of any certificate that he proposes to issue. The Attorney General or Commission may, within fifteen days thereafter, give written notice to the Secretary of an intent to offer advice on the determination. The Attorney General or Commission may, after giving such written notice and within forty-five days of the time the Secretary has delivered a copy of a proposed certificate, formally advise the Secretary of disagreement with his determination. The Secretary shall not issue any certificate prior to the expiration of such forty-five day period unless he has (A) received no notice of intent to offer advice by the Attorney General or the Commission within fifteen days after delivering a copy of a proposed certificate, or (B) received any notice and formal advice of disagreement or written confirmation that no formal disagreement will be transmitted from the Attorney General and the Commission. After the forty-five day period or, if no notice of intent to offer advice has been given, after the fifteen-day period, the Secretary shall either issue the proposed certificate, issue an amended certificate, or deny the application. Upon agreement of the applicant, the Secretary may delay taking action for not more than thirty additional days after the forty-five day period. Before offering advice on a proposed certification, the Attorney General and Commission shall consult in an effort to avoid, wherever possible, having both agencies offer advice on any application.

"(2) EXPEDITED CERTIFICATION.—In those instances where the temporary nature of the export trade activities, deadlines for bidding on contracts or filling orders, or any other circumstances beyond the control of the association or export trading company which have a significant impact on its export trade, make the 90-day period for application approval described in paragraph (1) of this subsection, or an amended application approval as provided in subsection (c) of this section, impractical for the association or export trading company seeking certification, such association or export trading company may request and may receive expedited action on its application for certification.

"(3) APPEAL OF DETERMINATION.—If the Secretary determines not to issue a certificate to an association or export trading company which has submitted an application or an amended application for certification, then he shall—

"(A) notify the association or export trading company of his determination and the reasons for his determination, and

"(B) upon request made by the association or export trading company afford it an opportunity for a hearing with respect to that determination in accordance with section 557 of title 5, United States Code.

"(c) MATERIAL CHANGES IN CIRCUMSTANCES; AMENDMENT OF CERTIFICATE.—Whenever there is a material change in the membership, export trade, export trade activities, or methods of operation, of an association or export trading company then it shall report such change to the Secretary and may apply to the Secretary for an amendment of its certificate. Any application for an amendment to a certificate shall set forth the requested amendment of the certificate and the reasons for the requested amendment. Any request for the amendment of a certificate shall be treated in the same manner as an original application for a certificate. If the request is filed within thirty days after a material change which requires the amendment, and if the requested amendment is approved, then there shall be no interruption in the period for which the certificate is in effect.

"(d) AMENDMENT OR REVOCATION OF CERTIFICATE BY SECRETARY.—After notifying the association or export trading company involved and after an opportunity for hearing pursuant to section 554 of title 5, United States Code, the Secretary, on his own initiative—

"(1) may require that the organization or operation of the association or export trading company be modified to correspond with its certification, or

"(2) shall, upon a determination that the export trade, export trade activities or methods of operation of the association or export trading company no longer meet the requirements of section 2 of this Act, revoke the certificate or make such amendments as may be necessary to satisfy the requirements of such section.

"(e) ACTION FOR INVALIDATION OF CERTIFICATE BY ATTORNEY GENERAL OR CHAIRMAN—

"(1) The Attorney General or the Commission may bring an action against an association or export trading company or its members to invalidate, in whole or in part, the certification on the ground that the export trade, export trade activities or methods of operation of the association or export trading company fail or have failed, to meet the requirements of section 2 of this Act. The Attorney General or Commission shall notify any association or export trading company or member thereof, against which it intends to bring an action for revocation, thirty days in advance, as to its intent to file an action under this subsection. The district court shall consider any issues presented in any such action de novo and if it finds that the requirements of section 2 are not met, it shall issue an order declaring the certificate invalid and any other order necessary to effectuate the purposes of this Act and the requirements of section 2.

"(2) Any action brought under this subsection shall be considered an action described in section 1337 of title 28, United States Code. Pending any such action which was brought during the period any exemption is held in abeyance pursuant to section 2(c) of this Act, the court may make such temporary restraining order or prohibition as shall be deemed just in the premises.

"(3) No person other than the Attorney General or Commission shall have standing to bring an action against an association or export trading company or their respective members for failure of the association or export trading company or their respective export trade, export trade activities or methods of operation to meet the criteria of section 2 of this Act.

"SEC. 5. GUIDELINES.

"(a) INITIAL PROPOSED GUIDELINES.—Within ninety days after the enactment of the Export Trade Association Act of 1980, the Secretary, after consultation with the Attorney General, and the Commission shall publish proposed guidelines for purposes of determining whether export trade, export trade activities and methods of operation of an association or export trading company will meet the requirements of section 2 of this Act.

"(b) PUBLIC COMMENT PERIOD.—Following publication of the proposed guidelines, and any proposed revision of guidelines, interested parties shall have thirty days to comment on the proposed guidelines. The Secretary shall review the comments and, after consultation with the Attorney General, and Commission, publish final guidelines within thirty days after the last day on which comments may be made under the preceding sentence.

"(c) PERIODIC REVISION.—After publication of the final guidelines, the Secretary shall periodically review the guidelines and, after consultation with the Attorney General, and the Commission, propose revisions as needed.

"(d) APPLICATION OF ADMINISTRATIVE PROCEDURE ACT.—The promulgation of guidelines under this section shall not be considered rulemaking for purposes of subchapter II of chapter 5 of title 5, United States Code, and section 553 of such title shall not apply to their promulgation.

"SEC. 6. ANNUAL REPORTS.

"Every certified association or export trading company shall submit to the Secretary an annual report, in such form and at such time as he may require, which report updates where necessary the information described by section 4(a) of this Act.

"SEC. 7. OFFICE OF EXPORT TRADE IN COMMERCE DEPARTMENT.

"The Secretary shall establish within the Department of Commerce an office to promote and encourage to the greatest extent feasible the formation of export trade associations and export trading companies through the use of provisions of this Act in a manner consistent with this Act.

"SEC. 8. AUTOMATIC CERTIFICATION FOR EXISTING ASSOCIATIONS.

"The Secretary shall certify any export trade association registered with the Federal Trade Commission as of April 3, 1980, if such association, within one hundred and eighty days after the date of enactment of such Act, files with the Secretary an application for certification as provided for in section 5 of this Act, unless such application shows on its face that the association is not eligible for certification under this Act.

"SEC. 9. CONFIDENTIALITY OF APPLICATION AND ANNUAL REPORT INFORMATION.

"(a) GENERAL RULE.—Portions of applications made under section 4, including amendments to such applications, and annual reports made under section 6 that contain trade secrets or confidential business or financial information, the disclosure of which would harm the competitive position of the person submitting such information shall be confidential, and, except as authorized by this section, no officer or employee, or former officer or employee, of the United States shall disclose any such confidential information, obtained by him in any manner in connection with his service as such an officer or employee.

"(b) DISCLOSURE TO ATTORNEY GENERAL OR COMMISSION.—Whenever the Secretary believes that an applicant may be eligible for a certificate, or has issued a certificate to an association or export trading company, he shall promptly make available all materials filed by the applicant, association or export trading company, including applications and supplements thereto, reports of material changes, applications for amendments and annual reports, and information derived therefrom. The Secretary shall make available applications, amendments thereto or annual reports, or information derived therefrom, to the Attorney General or Commission, or any employee or officer thereof, for official use in connection with an investigation or judicial or administrative proceeding under this Act or the antitrust laws to which the United States or the Commission is or may be a party. Such information may only be disclosed by the Secretary upon a prior certification that the information will be maintained in confidence and will only be used for such official law enforcement purposes.

"SEC. 10. MODIFICATION OF ASSOCIATION TO COMPLY WITH UNITED STATES OBLIGATIONS.

"At such time as the United States undertakes binding international obligations by treaty or statute, to the extent that the operations of any export trade association or export trading company, certified under this Act, are inconsistent with such international obligations, the Secretary may require it to modify its operations so as to be consistent with such international obligations.

"SEC. 11. REGULATIONS.

"The Secretary, after consultation with the Attorney General and the Commission, shall promulgate such rules and regulations as may be necessary to carry out the purposes of this Act.

"SEC. 12. TASK FORCE STUDY.

"Seven years after the date of enactment of the Export Trade Association Act of 1980, the President shall appoint, by and with the advice and consent of the Senate, a task force to examine the effect of the operation of this Act on domestic competition and on United States international trade and to recommend either continuation, revision, or termination of the Webb-Pomerene Act. The task force shall have one year to conduct its study and to make its recommendations to the President.".

(b) REDESIGNATION OF SECTION 6.—The Act is amended—

(1) by striking out "SEC. 6." in section 6 (15 U.S.C. 66), and

(2) by inserting immediately before such section the following:

"SEC. 14. SHORT TITLE.".

TITLE III—TAXATION OF EXPORT TRADING COMPANIES

APPLICATION OF DISC RULES TO EXPORT TRADING COMPANIES

SEC. 301. (a) Paragraph (3) of section 992(d) of the Internal Revenue Code of 1954 (relating to ineligible corporations) is amended by inserting before the comma at the end thereof the following: "(other than a financial institution which is a banking organization as defined in section 105(a)(1) of the Export Trading Company Act of 1980 investing in the voting stock of an export trading company (as defined in section 103(5) of the Export Trading Act of 1980) in accordance with the provisions of section 105 of such Act)".

(b) Paragraph (1) of section 993(a) of the Internal Revenue Code of 1954 (relating to qualified export receipts of a DISC) is amended—

(1) by striking out "and" at the end of subparagraph (G),

(2) by striking out the period at the end of subparagraph (H) and inserting in lieu thereof "and", and

(3) by adding at the end thereof the following new subparagraph:

"(I) in the case of a DISC which is an export trading company (as defined in section 103(5) of the Export Trading Company Act of 1980), or which is a subsidiary of such a company, gross receipts from the export of services produced in the United States (as defined in section 103(3) of such Act) or from export trade services (as defined in section 103(4) of such Act).".

(c) The Secretary of Commerce, after consultation with the Secretary of the Treasury, shall develop, prepare, and distribute to interested parties, including potential exporters, information concerning the manner in which an export trading company can utilize the provisions of part IV of subchapter N of chapter 1 of the Internal Revenue Code of 1954 (relating to domestic international sales corporations), and any advantages or disadvantages which may reasonably be expected from the election of DISC status or the establishment of a subsidiary corporation which is a DISC.

(d) The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1980.

SUBCHAPTER S STATUS FOR EXPORT TRADING COMPANIES

SEC. 302. (a) Paragraph (2) of section 1371(a) of the Internal Revenue Code of 1954 (relating to the definition of a small business corporation) is amended by inserting ", except in the case of the shareholders of an export trading company (as defined in section 103(5) of the Export Trading Company Act of 1980) if such shareholders are otherwise small business corporations for the purpose of this subchapter," after "shareholder".

(b) The first sentence of section 1372(e)(4) of such Code (relating to foreign income) is amended by inserting ", other than an export trading company," after "small business corporation".

(c) The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1980.

The CHAIRMAN. Thank you, Mr. Sprague.

Governor Wallich.

Mr. WALLICH. If I may, I would like to read my statement. It is quite brief.

The CHAIRMAN. Very well. Go right ahead.

Mr. WALLICH. I am pleased to testify on S. 2718, a bill that would facilitate the establishment and operation of export trading companies.

At the outset, I should like to reaffirm the view of the board that the United States needs a strong export sector. The development of export trading companies will probably assist in achieving this goal, although in my view, fundamental economic factors, such as U.S. price performance and exchange rates, will continue to be the most important factors. Banks have an important role to play in financing U.S. exports, and banks can assist export trading companies in this country by providing financing and by offering a wide range of export-related services. But bank ownership of trading companies raised broad issues of public policy, some of which were set forth in an earlier statement submitted to this committee.

My statement today on behalf of the Board of Governors is limited to the issues raised by provisions for bank ownership of trading companies, and possible ways of dealing with these issues.

The separation of banking and commerce has a long tradition in American banking and is embodied in several banking laws, most notably the Bank Holding Company Act and the Glass Steagall Act. The Federal Reserve believes that this separation has been a major element of strength for the American banking system and the American economy.

MAIN PROBLEMS

While I covered many of the problems involved in permitting significant bank ownership of trading companies in my earlier statement submitted to the committee, I would like to briefly summarize the main problems.

Banks that are engaged in commercial trading may be exposed to high risks, particularly when leveraging is involved, as is typically the case with trading companies. This risk could well be much larger than the original investment. I might note that a few years ago, a Japanese bank reported losses of one-half billion dollars from the failure of a major trading company with which it was closely associated.

Bank supervisors would be involved to a substantial degree in decisions regarding the operations of trading companies; and the regulations necessary to protect banks from a range of possible future problems could well hamper the operations of these trading companies.

Bank-owned trading companies and their clients may have access to credit on more favorable terms than other companies; alternatively, large banks could use bargaining power obtained through trading company affiliates to obtain an increasing share of the banking business of client firms. Although regulations can help avoid the most blatant types of abuse—and the bill includes provisions regarding terms of credits—it would be a difficult task to supervise credit judgments through regulations with the specificity needed to insure protection from unfair competition.

In light of these problems, the Federal Reserve has tried to design safeguards that would make it possible to permit a degree of bank participation in export trading companies without breaching the separation of banking and commerce. In this connection, it needs to be recognized that trading companies may be engaged in importing, and thus involved in some commercial activities in the United States, as well as in commercial activities abroad. Most of the board's recommendations have been incorporated in S. 2718, and they have helped strengthen the provisions of the bill by reducing the risks to banks. But two important provisions were omitted, and because the board's recommendations represented an integrated proposal, the omissions substantially reduce the protections which the Federal Reserve believes are needed.

In particular, the Board urges that S. 2718 be further amended to provide that: One: A banking organization be permitted to invest in an export trading company only up to 20 percent of the shares of the trading company; and Two: A group of banking organizations could not own more than 50 percent of the voting stock of any single export trading company.

I should like to provide some background.

Although there may be debate on the exact percentage of equity interest at which an investor ceases to be essentially a portfolio investor and becomes actively associated with management, the best guideline appears to be the point at which an investor can make use of equity accounting—generally 20 percent. Where an ownership interest is 20 percent or more, accepted standards of accounting normally call for a bank—or any company—to include on its balance sheet and income statements its proportionate share of the net assets and earnings of a company. Experience in international banking has generally shown that where bank ownership in a foreign company permits the use of equity accounting, the bank frequently tends to become involved in management aspects of the business and to be identified with the company in the eyes of the financial community. Where such identification exists, a bank may find it necessary to stand behind all of the liabilities of a company in case of financial difficulties, in order to preserve the bank's standing in international financial markets. In the case of companies that are highly leveraged, a bank's potential loss could well be much larger than the original investment.

By contrast, at levels of ownership interest at which equity accounting does not apply, the immediate rewards to an investing bank would be the dividends it might receive on shares and income from loans or services provided to the trading company. Under those circumstances, a bank would tend to treat a trading company on an arms-length basis, and the bank's reputation would not become clearly associated with that of the company in which it had invested.

To strengthen its recommedation on limiting ownership interests, the Federal Reserve earlier proposed that an export trading company could not bear the name of an investing bank nor represent that it was affiliated with a bank. Provisions to accomplish this have been included in S. 2718. As we saw in the case of REIT's in the mid-1970's, public identification of a bank with another enterprise can involve the bank in substantial potential commitments and, in the case of difficulties, in substantial losses, even where there is no bank ownership interest. However, where a significant ownership interest exists, even if there is no public identification through the name of the trading company, there is also a likely commitment on the part of the bank. Thus, in devising rules for export trading companies where bank investments are contemplated, it is necessary to couple the restriction on public identification of banks and trading companies with a limitation on bank ownership interests.

It is sometimes argued that banks can better limit their risks by maintaining control over their affiliates. This proposition may well be valid in the case of commercial banking affiliates; it does not, however, represent a basis for preferring to allow a bank to acquire control over a commercial firm rather than to limit bank involvement in management of that firm through restrictions on bank ownership.

The philosophy of the Federal Reserve proposals—that bank ownership and management of trading companies should be limited—was designed not only to reduce risks to banks, but also to hold to a minimum the need for regulation of the operation of export trading companies, while permitting banks to provide some financial support. Underlying this approach is the view of the Board that bank supervisors need to develop ways of reducing the burden of supervision, both on the supervisory agencies and on the banking community. In the area of international banking, the Board has taken some steps to implement this view in revising its regulation K last year, and the Board staff is reviewing proposals that would further reduce the regulatory restrictions on edge corporations.

ACTIVITIES NOT PERMISSIBLE UNDER LAW

The export trading companies provided for in S. 2718 would be organized and operated principally for the purpose of exporting goods or services produced in the United States as well as providing services to facilitate such exports. If U.S. banks were to have important ownership and management interests in trading companies, they would be engaged indirectly in a host of activities not currently permissible under U.S. law. For example, under the act, trading companies could purchase for export commodities and manufactured goods, and could provide services in such fields as accounting, tourism, engineering, architecture, and transportation. U.S. banking organizations do not have extensive experience in these nonbanking activities, nor do the bank supervisory agencies.

The bill directs the bank regulatory agencies to establish standards to insure against unsafe or unsound export trading company practices that could affect any banking organization that controlled a trading company. Development of the requisite expertise to cope with the almost limitless range of activities that would be permitted to export trading companies under S. 2718 would be time consuming and costly to the bank regulatory agencies. If banks owned trading companies, they would, of course, also need to develop expertise in those lines of activity in which the trading company specialized. In sum, in view of the risks of bank ownership of trading companies, and the large costs that would be associated with efforts to control those risks through regulation, we believe there is a basic presumption that bank ownership should only be allowed on a scale that does not involve an important management interest.

The second Board recommendation was that S. 2718 contain a limit on the total investment in a single export trading company by all banking organizations combined. If banks, as a group, controlled a trading company, the banks would likely be identified with the company, even though none had an interest of 20 percent or more. This identification could expose the investing banks to the risk of large losses in the event of the failure of the trading company.

These recommended restrictions on bank investment do not represent severe restraints on the operations of export trading companies. For example, under the Federal Reserve proposal, three banks together could supply up to 50 percent of the capital of a trading company. And that trading company would be able to operate on the basis of its own business judgment without being subject to the special operating rules established by bank supervisory agencies that are contemplated under S. 2718.

Moreover, banks can provide support to trading companies in a number of ways apart from equity investments. First among these is financing—the area in which the bank's expertise is likely to be of greatest value to the trading company. The Federal Reserve proposals contemplated that a banking organization could lend to any single export trading company an amount which together with its investment in that compnay would not exceed 10 percent of the bank's capital, while total equity investment by a bank in one or more trading companies could not exceed in the aggregate 5 percent of the bank's capital. Such loans could be made by the bank, its edge corporations, or other holding company affiliates.

These different members of a banking organization could also provide other services, such as foreign exchange, information on foreign markets, letters of credit, advice on arranging shipments, and insurance brokerage. I recognize that under the Board's regulation K, it would not be possible for edge corporations to supply to export trading companies the full range of services that a bank could supply, and I believe that it would be appropriate to allow edge corporations additional authority to enable them to assist export trading companies. The Board might, under appropriate restrictions, create for export trading companies a special status under regulation K similar to that proposed last year for domestic qualified business entities—a proposal on which the Board has not yet acted.

Moreover, I should note that regulation K provides that edge corporations will apply to the Board to engage in providing services that would be incidental to international or foreign business, and the Board may expand that list of permissible financial services on the basis of the facts submitted in the applications.

In conclusion, I should reemphasize that the U.S. economy would best be served by having banking organizations assist trading companies as bankers and limited investors rather than as owner operators of these firms. This will permit banks to provide the financially related services in which they have expertise, while permitting trading companies to innovate unfettered by regulation of their activities. At the same time, it will preserve the separation of banking and commerce and the role of banks as the impartial arbiters of credit.

The CHAIRMAN. Thank you. Mr. Sprague, you mentioned staff reservations about your statement. What are they?

STAFF RESERVATIONS

Mr. SPRAGUE. Well, they really go to the heart of the matter, Senator. As I suggested in my opening remarks, our agency is charged with protecting the people's deposits and, to the best of our ability, provide safety and soundness in the banking institutions.

As recently as the sixth draft of this testimony, the director of my division of bank supervision and his entire staff strongly urged me to come today, and flatly oppose the bill on two bases. One: That we're taking an historic step in separating banking and commerce and, although this would be a very modest incursion, it might well be the beginning of a major change in our national policy that could make our job much more difficult and might well be bad for the Nation.

The further reservation went to the open-ended provisions in the bill, which would allow something up to one-half of the trading company activity to be in an uncharted area. We do not know what they would be doing. We suspect that they would be doing things in areas where we do not have experience and the banks would not have the appropriate expertise.

We have had considerable discussion about this legislation since members of Senator Stevenson's staff talked to me a few weeks ago and advised that your committee was very interested in our opinions and attitudes, which we had not seriously addressed up until that time.

On balance, at the close of business Wednesday, everybody was aboard and the staff had accepted my position that the more responsible approach would be to accept the fact that Congress has wider responsibilities than we do and must address greater problems, and our effort should be to get incorporated into the legislation, if we could, as many safeguards as we believe necessary.

I thought in fairness I should give you that background on the reservations, but as of this morning I can state that the entire senior staff and two directors are in full accord with my statement today.

The CHAIRMAN. I want to make sure I understand how your statement comes down. You say on page 3 at the top: "If you proceed, we suggest you allow something less than a controlling interest by banking organizations in export trading companies."

The bill in its present form permits a controlling interest. In its present form, do you oppose the bill because it does not follow your views?

Mr. SPRAGUE. That is correct.

The CHAIRMAN. You do oppose the bill.

Mr. SPRAGUE. That is correct.

The CHAIRMAN. I would like to ask you, Mr. Wallich, in your statement on page 2 you state the admission would substantially reduce the protections which the Federal Reserve believes we need.

In particular, bottom of page 2, the Board urges S. 2718 be further amended to provide that a banking organization be permitted to invest only up to 20 percent of the trading company and so forth. Does that mean that unless that amendment is provided, that the Fed would be opposed to the legislation?

Mr. WALLICH. We would be unable to support it; yes, Mr. Chairman.

The CHAIRMAN. All right. Now, this legislation would permit among other things large banks to establish export trading companies, which can buy for their own account and inventory for subsequent resale overseas, machinery and equipment among other goods and products. To what extent should we be concerned that companies which have a banking relationship with banks, not only export trading companies, would switch their banking business in the hope they might be favored by bank-owned export trading companies buying their products?

Mr. WALLICH. This is one of the possible things that can happen. The possibilities here are very wide because the activities of the trading companies necessarily must be quite far reaching and unconfined.

So the fear that there may be less than arms-length relationships developing, I think, is a well founded one. Now, one can try to guard against that by appropriate regulatory action concerning a differentiation of the terms of a credit. But the fact of the availability and the appropriateness of a loan is very difficult to submit to regulatory judgment.

RISKS FOR BANKS

The CHAIRMAN. In discussing the risks for banks associated with the control of export trading companies, Mr. Sprague, you expressed skepticism that banks have any particular expertise in foreign markets other than perhaps a few monsters of major regional banks. How about these banks?

The legislation would allow an export trading company to engage in construction, own a shipping line, take positions in wheat and import commodities into the United States by way of barter deals and presumably market them in the United States. These activities do not appear to be very closely related to finance and trade. What expertise do banks have to engage in these activities?

Mr. SPRAGUE. We attempted to identify that expertise in our discussions and came up empty except in isolated instances. This is one of the reasons why we suggested a closely related type of amendment which would narrow as much as possible the types of endeavors trading companies would get into should the legislation be enacted.

If the banks were just investors and lenders, then with the restrictions Governor Wallich has suggested, I would submit the trading companies could have much wider latitude and proceed to innovate and do their thing. Some, I am sure, would be very successful. Some, I imagine, would fail.

The CHAIRMAN. So you want to keep banks in banking and finance completely and not in the other businesses.

Mr. SPRAGUE. Essentially, yes.

The CHAIRMAN. Mr. Wallich, on page 3 of your statement you say—that was an interesting technical factor a lot missed—"experience in international banking generally shows where bank ownership in a foreign country permits the use of equity accounting, the bank frequently intends to become involved in management aspects of the business and become identified with the companies in the eyes of the community. The bank has a strong incentive to bail out the business involved even beyond the capitalized investment."

Can you give us examples of that experience?

Mr. WALLICH. There have been examples of banks that engaged in financing of real estate activity in a way that didn't seem to obligate them to take full responsibility for what happened, but in the end it turned out that they felt they had to back the venture fully. That is perhaps the most outstanding example.

It's quite generally recognized, I think, that banks do tend to stand back of an activity when their association with it is clearly recognized. Equity accounting is one threshhold and indication of identification with the activity. There are others we pointed to such as using the same name as the bank.

The CHAIRMAN. Wasn't there a subsidiary of United California Bank with a subsidiary in Switzerland——

Mr. WALLICH. The case of speculation. That was an instance, I think, of identification between the bank and the subsidiary. There was no legal obligation for the bank to back the subsidiary, but nevertheless, they did so to protect their good name.

The CHAIRMAN. Would you agree this legislation would add substantially to the capital problems of large banks which are already thinly capitalized?

Mr. WALLICH. Well, it certainly would add to those. Banks are thinly capitalized. Here we presumably would find both the volume of loans rising somewhat as a result of these activities and the degree of risk involved. So I think one would have to say that there would be an increasing demand on the capital of banks.

Now, the report speaks of $1 billion over a period of 5 years as the total involvement. That does not seem to be a very large amount. On the other hand, one has to think of the possible leveraging of trading companies that could go with that, depending on the kind of thing they do. That could be a very considerable multiple of capital, and in that case there would surely be an added demand on capital.

The CHAIRMAN. My time is up. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman. First, I would like unanimous consent that my opening statement appear.

The CHAIRMAN. Without objection, so ordered.

[Statement of Senator Heinz follows as though read:]

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, even though I personally believe that we have fully examined all the issues associated with this bill, I am willing to spend additional time in the hope that it will expedite bringing the export trading company bill to the floor. I believe that we must decide now whether we are going to have a national export policy that is more than simply rhetoric. The administration and the Congress agree that increasing this Nation's exports ought to be a top priority. The enthusiastic support which the administration has provided for the export trading company legislation is a good indicator, I think, that the executive branch agrees that something tangible and positive is going to have to be done to reverse the dismal trend toward the ever-widening trade deficit that we have seen during the past 3½ years.

Let's face it, little else is being done. This is the only game in town. If we fail to pass this legislation this year, a significant opportunity will have passed us by. The 96th Congress will have adjourned with nothing—other than the revised Export Administration Act—to show for its efforts to promote U.S. exports. Those who oppose this legislation will have to go back to their constituents and explain why—in the face of a $100 billion cumulative trade deficit over the past 3½ years—they rejected the one piece of legislation which might have made a dramatic difference.

Both our budget deficits and our trade deficits are increasing. There is an obvious relationship. Increased exports lead to increased employment, which, in turn, leads to increased inflows to the Treasury and decreased outflows. I have cited the facts on numerous occasions before, but it bears repeating. Increasing exports by $1 billion creates around 50,000 jobs, and removing 50,000 people from unemployment is worth $1 billion to the Treasury in increased revenues and avoided transfer payments. This legislation will increase our exports with minimal budget outlays. It is not a subsidy or a welfare program. To the contrary, it is a program to remove the restraints that we have put on our current exporting community and on our potential exporting community. It will help to create structures which foster exports and put Americans to work by presenting opportunities for entrepreneurs and the "Yankee Trading Spirit" to exploit. That is the essence of this legislation.

Allowing the participation of the banking organizations in export trading companies does involve some risk but the provisions of this bill limits their financial exposure to such a degree that the risk is quite minimal if not as close to nonexistent as can be obtained in an uncertain world. At this point, isn't it more important to ask, what do we risk if we do not act to increase our exports? That risk is known. Our trade deficit will continue to grow. If we assume that we will continue with the same track record for 1980 as in the first quarter of this year, we will have a $44 billion deficit. $14 billion more than last year. Things are going from bad to worse, and something must be done. Our budget deficit is also growing as I stated earlier. For the first 8 months of fiscal year 1980 the budget deficit is $56 billion. For the same period last year, it was $36 billion. That has not doubled as the trade deficit has, but it is definitely a trend that must be stopped.

I understand that the Federal Reserve Board and the FDIC are primarily concerned about allowing the banking organizations to obtain control of the export trading companies, because this increases their risk. The bill already contains many limitations designed to minimize the risk to the banking organizations. One of those is that prior approval must be obtained before they can assume a controlling interest. Therefore, it seems to me that the risks that the regulatory bodies see should be taken care of in the conditions that they impose before approval is granted. Actually, I think that there are some good arguments for the position that allowing a bank to gain control actually reduces the risk. It gives them the legal ability to insure that the ETC is operating in a safe and sound manner. In addition, it can actually work to reduce the possibility of conflict by allowing a bank to form a company to serve all its customers without being in partnership, a minority partnership if control is disallowed, with some of their customers.

In evaluating the relative risks involved in an enterprise, we should consider all the possibilities. In this case, we must weigh the risk to the banks of their involvement against the benefits to our economy which will be accrued by increased exports. The sponsors of this legislation believe that ETC's will significantly increase U.S. exports—particularly those of small- and medium-sized businesses—if they are adequately capitalized, and that at this point, the most effective way for ETC's to raise capital is to encourage banks to get into the business. If the Senate takes actions that will discourage the participation of banks in ETC's, it will have significantly decreased the probability that this legislation will be an effective vehicle with which to obtain the goal of increased exports.

Mr. Chairman, as the committee has already reported the bill out, I sincerely hope that at the conclusion of this hearing the bill will be allowed to go to the Senate floor and let our colleagues decide whether it is time to create an environment which will encourage and be more conducive to exports. I am even hopeful that you will become a supporter and assist in the passage of the bill.

Mr. Sprague, a few moments ago Senator Proxmire asked you whether or not you opposed the bill in its present form and you said, in its present form you oppose it. If it were changed along the lines suggested, you would not. Is that correct?

Mr. SPRAGUE. Basically, yes. Along the lines suggested—there have been a number of suggestions, but the basic issue is control.

Senator HEINZ. Now, has your Board voted to take such a position?

Mr. SPRAGUE. No.

Senator HEINZ. What was the answer?

Mr. SPRAGUE. No.

Senator HEINZ. Your Board has not voted to oppose this bill; is that correct?

Mr. SPRAGUE. That is correct.

Senator HEINZ. So, the opinion you express is strictly a personal opinion at this point.

Mr. SPRAGUE. No, sir; the opinion I expressed is clearly the majority opinion of our Board. We have an unusual Board. We are an independent agency——

Senator HEINZ. The Board has not voted. I do not know how you can say it is an official action of the FDIC.

Mr. SPRAGUE. Technically, that is correct, I am sure. But our Board has one member whose point of view incorporates additional considerations. That is the Comptroller of the Currency. He will have testimony which I am certain is somewhat at variance.

So, in presenting this opinion, I do not present an opinion that does not carry the majority support of the Board. I might state, so there is no misunderstanding, that the other director of the Board, Bill Isaac, strongly supports this position.

Senator HEINZ. I am not so sure. I talked with Mr. Isaac last night.

Mr. SPRAGUE. He talked to me after his conversation with you and said [laughter] he said you had a long conversation.

Senator HEINZ. I am sure it was a long conversation.

The CHAIRMAN. If the Senator would yield, we could have an additional hearing in a few weeks and have Mr. Isaac up here.

Senator HEINZ. My point, Mr. Chairman, is that it was clear in my conversation with Mr. Isaac that even he, who is very well versed in this and had a lot of discussion with you, finds this a difficult issue. He has not heard necessarily all the arguments.

There is a difference between a chairman calling up members of the Board and saying, do you agree with me or not, and a Board actually being put to the test. I seek to do in my limited time is to make it clear that the Board has not voted an opinion on this.

Mr. SPRAGUE. Off the record I could assemble——

Senator HEINZ. I would like to ask you another question.

Since the heart of the problem here, it is that the staff is against taking any historic steps. That is what you said in your testimony, as I understand it, or in your response to Mr. Proxmire, and that there is a fear of the unknown, which is not unusual in human behavior.

Indeed, we are looking to take some historic steps because history is not on our side to date. The Japanese and others seem to be rewriting history. As they go ahead, to their advantage, we sit on the sidelines and are dealt out.

The fact that we may be taking an historical step could be viewed by an awful lot of people as a very good thing. We have a trade deficit, at least up until the President made his midyear review last week, that is bigger than our budget deficit.

Now, the budget deficit seems to be going beyond our trade deficit but you never know in this day and age. Let me ask Mr. Wallich: You indicated that you were concerned about what might be called loan bias, if a bank had control.

RISK OF LOAN BIAS

There were two issues you identified sectionally. This issue of control and risk. And you said, as I understood your testimony, that it could be guarded against but not eliminated—the risk of loan bias—and the following thoughts occur to me.

First of all: Your statement is accurate. Second: That the amount of risk that can be guarded against would be under our legislation, subject to your control to a very large extent. For example, any bank seeking control has to do so under guidelines approved by our bank regulators.

Third: It occurs to me that notwithstanding the almost limitless authority that banks had to get involved in REIT, an experience far beyond what we would seek to allow in this instance, that you did a very good job.

It wasn't easy, but the bank regulators as a whole did a very good job in saving some of the banks from their own enthusiasm and perhaps lack of wisdom. And the world did not come to an end. We are all here. Some banks had some narrow escapes.

Finally, I am interested in the fact that right now there is already precedent for banks to have a controlling interest in organizations that have nothing to do with banking which, Mr. Sprague, your staff should be aware of—they probably are—the historic step may already have been taken, at least as I read the Small Business Investment Corporation Act where a bank may, under the 1976 amendments, own virtually all of a SBIC.

So my question, Governor Wallich, is this: Sure, there is always a risk in doing something that we have not done before. There is an attitude, I know, pervasive in the country that we want a risk-free society. When we achieve that, we probably will have a reward-free society as well. Is the level of risk that you are worried about really something that in the scheme of things is so large that it should prevent us from obtaining some of these necessary benefits, at least as you see it?

Is the risk really a major kind of risk as measured against some of the other kind of risks we have survived?

Mr. WALLICH. I think the risks are real. I don't mean to impugn the good faith of bankers. I am sure that they mean to play by the rules. At the same time, they are human and their judgment can be diverted in the direction favoring their banks.

Likewise concerning the exposure on the commitments of a trading company, one normally would expect banks to manage their affairs well, but there is always some fraction where perhaps that assurance is not so great. One needs only a very few incidents in order to produce a possibly very bad situation.

Now, pitted against that is the question: How urgently needed are these control powers in banks? I hope I am not being interpreted as downgrading the importance of exports.

They are extraordinarily urgent for our economy. Likewise, I think trading companies are an excellent vehicle, although I am puzzled why the market has not so far tended to produce them in our country where they have come about in other countries.

Senator HEINZ. That is addressed in the other titles of the bill as well as this particular title.

Mr. WALLICH. Weighing the gains that could come from bank control and in view of the very large precedent that we move into here, I come to the conclusion that we should back away from this.

Now, I could visualize, as Chairman Volcker wrote to Senator Stevenson, there could be very special cases in which this general principle of separation of banking and commerce could be looked at carefully, but certainly only without bending the general rule of separation.

Likewise, in testimony not long ago I said we probably ought to rethink the whole problem of a separation of banking and commerce, but I would not pitch it on a relatively limited issue such as whether a bank can own 20 percent or not of an export trading company.

Senator HEINZ. I think it is a limited issue. I think it is a good issue. I think a very good way to approach the issue is case by case.

And we are doing it in two ways, really. I realize that my time has expired, but might I have an additional minute?

The CHAIRMAN. Is there objection?

Senator STEVENSON. No.

Senator HEINZ. First: Legislation provides that with all the safeguards—and as we know there are a lot of safeguards—there may not be as many as either of you want, but there are a lot—the safeguards in the legislation is one case.

Second: In the case of controlling interest, there is case-by-case approval given to you, which is about as careful an approach as anybody would ever want.

My thought would be that if you ever want to have any experience going beyond the conventional wisdom that banks should be narrowly restricted and should never stray across this magic line we have drawn, one of the things you can do is get a little experience before you have to make a momentous decision.

If this is a momentous decision, it is a smaller one rather a the larger one. I do not know whether you may have misunderstood my question. I had attempted to try to get you to characterize the amount of risk that is involved here.

Your argument really evolves around the question of risk. Supervisory burden, granted. But that is something that is a somewhat different issue. I may have misheard you but I did not hear you characterize whether you thought the risks were great or small or how you would put them in proportion to the kind of risks to which we have already seen an exposure taken, which have generated varying degrees of results.

Mr. WALLICH. The potential for incurring risk is very large. That is to say, even after the legislative safeguards and the case-by-case regulatory approvals, a bank controlling a trading company could get itself into deep trouble by accepting ownership of assets that could fluctuate in value and could compel the bank to bail out the trading company at a loss to itself.

I am not saying this will happen very often. A well-managed bank, even if it has the opportunity, is not going to do that. Nevertheless, our legislation always seeks to protect the bank against that kind of error, and here the door is open.

Senator HEINZ. I understand what you said. I am trying to put the risk into larger context, suppose a bank does get overexposed, does something wrong, is stupid, how large a risk is that to society?

It seems to me that we have been through a far larger risk with REIT's and potentially SBIC's than we might have here.

I am trying to get you to characterize the risk in that framework, not as to an individual bank, but the risk to our banking system and our economy. It seems to me it is that scale and frame of reference that is important here.

I know I have taken too much time. I apologize to my colleagues.

The CHAIRMAN. Senator Stevenson.

Senator STEVENSON. Thank you, Mr. Chairman.

Governor Wallich, a moment ago you puzzled aloud over why the market has not produced trading companies here as it has in other nations. Senator Heinz and I began puzzling that same question several years ago when we began our studies on the competitiveness of the United States, including our efforts of some years duration now on export policy in this committee.

REPEAL CERTAIN REGULATORY IMPEDIMENTS

It was that puzzlement which produced this legisation. We identified, we believe, the reasons, and they reside in the antitrust laws and the banking laws of the United States. Therefore, we introduced legislation to do nothing, really, except to repeal certain regulatory impediments to the creation of trading companies by the American marketplace.

That is all that will really be done by this deregulation bill. But that deregulation does break with tradition.

I have great respect for you. You are a thoughtful and wise man. I was much impressed by something you said on June 25, before the Committee on Government Operations of the House. You said:

> I believe that a country that has lost two-thirds of its productivity growth like ours for a period of 15 years probably needs to rethink whether it can continue to afford the undoubted blessings of its separation of banking and commerce. It has to do with productivity and with growth.

Now, I am coming to a question, Mr. Chairman, but to put all this into a little bit more balance I would like to read from the testimony of the public official with responsibility for supervision of some 5,000 American banks and the majority of bank assets in the United States. He takes a global view. I regret he could not be here this morning but I gather Mr. Heimann is abroad.

I trust his testimony has been entered in the record. If not, I would offer it for the record.

The CHAIRMAN. It has been placed in the record (see p. 273).

Senator STEVENSON. He says:

> U.S. banking organizations should play a significant role in the development of export trading companies. They can contribute significantly to U.S. export capabilities in several ways. Banks have extensive national and international networks comprised of branches, subsidiaries, affiliates, representative offices, correspondent relationships. These networks not only can provide essential marketing and other services abroad, but more importantly, these networks extend thorughout the U.S. touching virtually all small- and medium-sized firms.
>
> Second, U.S. banks can provide through that network a wide range of export-related financing as well as ancillary services such as assistance and guidance and identification in foreign market exchange trade documents, transportation, and warehousing.
>
> Third, banks can provide export trading companies the financing necessary for export transactions.
>
> Major banks involved in export trading companies provide a general single source service for exporters abroad. U.S. banks, however, are not authorized under existing laws to offer the complete range of services essential to attract small-and medium-sized U.S. firms into exporting their goods and services.

I might add the Commerce Department estimates there are some 20,000 potential exporters, small-, medium-sized firms in the United States.

> Traditionally the export promotion efforts of U.S. banking organizations have been adjunct to overall commercial lending because their operations have been legally confined to those activities considered to be closely related to the business of banking. U.S. banking organizations have the systems, skills, and experience necessary to provide one-stop export services to U.S. firms, but need broader authority to do so.
>
> S. 2718 would provide that authority, . . . U.S. bank investment in trading companies would facilitate achievement of the underlying purposes of the proposed legislation. With equity participation in ETC's banks could readily package essential one-stop exporting services which would greatly reduce the expertise, overhead, and experience required of individual firms seeking to sell abroad.

There are other reasons why S. 2718 properly permits U.S. banks to invest in ETC's. First, the investment authority contained in S. 2718 would increase the number of possible investors and available capital to form trading companies.

Second, banks with their international offices, experience, trade finance, and familiarity with domestic U.S. producers are likely sources of leadership forming trading companies. They possess many of the skills important to trading company organization and management.

Third, their investment in trading companies would provide banking organizations with an incentive to create the long-term organizational framework necessary to accommodate export promotion as a mainstream function.

Finally, by permitting U.S. banking organizations to hold equity investments in trading companies, S. 2718 would rationalize the present system of authorities. U.S. banks are presently permitted to be involved in foreign trading companies which can buy and sell goods and services abroad. Foreign banks operating in the United States may own a foreign trading company which can export goods to the United States. . . . We support the provisions of S. 2718 which provide for U.S. banking organizations to own a controlling interest in Etcs. This office generally prefers banks to have equity and management control over their affiliate relationships rather than have that capital exposed to decisions by majority nonbank partners.

This is exactly what happened in the REIT situation as he points out.

He says: "The unfavorable bank experiences during the early 1970's with less than a controlling participation in REIT's." He also says: "Foreign banks and finance companies led U.S. banks to adopt strategies which generally avoid noncontrolling positions in affiliates." They don't want to be left to the mercy of nonbanking interests, interests that they can't control.

SAFEGUARDS

I am skipping now. But I do want to mention his comments about the safeguards that we have put in this bill to protect and preserve traditional separation and protect the condition of the banks without killing trading companies:

The proposed legislation contains several necessary supervisory safeguards regarding U.S. bank involvement in trading companies. It addresses entry and aggregate investment limitations.

U.S. banks can't invest more than $10 million or acquire a controlling interest in a trading company without prior agency approval. A U.S. bank would not be permitted to invest more than 5 percent of its capital and surplus in the stock of one or more trading companies. The aggregate amount of loans and investments a U.S. bank could make in a trading company would be limited to 10 percent of the bank's capital fund and no group of banks could acquire more than 50 percent of a trading company without prior agency approval, even if no one bank acquired a controlling interest or invested $10 million or more. The legislation would also establish other restrictions on banking organization investors in trading companies. The name of the trading company could not be similar in any respect to that of the banking organization investor. If a trading company takes speculative positions in commodities, all banking organization investors would be required to terminate their ownership interest.

A banking organization would be prohibited from making preferential loans to a trading company in which it has any interest or any customers of such a trading company. These limitations and restrictions have been structured to provide minimal financial exposure by banking organizations and trading companies and to prevent conflict of interest.

Most importantly, the bill provides substantial regulatory flexibility in the Federal financial supervisory agency to control investments by banking organizations and trading companies. If an agency determines that the anticipated export benefits of an investment are outweighed by adverse banking factors, the agency may disapprove an investment. Controlling investments in trading companies by banking organizations can otherwise be limited by conditions imposed by the agency that limit a banking organization's financial exposure or prevent possible conflict of interest or unsound banking practices.

By standards set by the agency regarding the taking of title to goods and inventory by the trading company subsidiary to ensure against unsafe or unsound practices that could adversely affect the controlling banking organization, et cetera.

We couldn't feel, therefore, that additional statutory restrictions such as the specific limit on maximum interest a banking organization may have in the trading company or a minimum capital ratio of a bank-owned trading company need be enacted.

Well, it goes on:

We fully support the objectives, the restrictions of the bill. The revisions on bank investment should adequately protect depositors. Limited opening of this area of activity in the banks create a unique U.S. export trading company system to allow more U.S. producers to benefit from existing international marketing networks and trade financing expertise.

Now, my question. [Laughter.]

Senator HEINZ. I will not object if you want a couple more minutes. [Laughter.]

Senator STEVENSON. I have 1 minute for my question. No? [Laughter.]

The CHAIRMAN. Go ahead. That was an interesting line of questioning so far. [Laughter.]

Senator STEVENSON. I thought it was pretty good. In fact, I answered all the questions. [Laughter.]

Thanks to Mr. Heimann. The concerns have been expressed here that these trading companies might get into nontrading activities. Our purpose is trade. That includes barter. It includes imports. It may include three and four country transactions, but its purpose is not manufacturing. Speculation in securities or underwriting securities or other such activities keep getting thrown up. If there is any doubt about that, I would be happy to support an amendment that would eliminate that doubt and make it crystal clear to whatever extent it is not clear now, that these trading companies have to be organized and operated for trading company purposes and no bank will be able to participate to any extent in trading companies which get involved in manufacturing, underwriting securities or any of these other activities which have been thrown up.

If we were to put together an amendment that eliminated that concern, would your attitude as far as this bill be changed?

Governor WALLICH. I would say it was an improvement, but there are so many other ways in which a bank can get itself into unanticipated trouble which do not contemplate securities operations. There are so many risks in trading that I do not think it would make a fundamental change. The fundamental point is control.

Senator STEVENSON. Mr. Sprague?

Mr. SPRAGUE. Well, as the bill proceeds, I hope you will go ahead with that kind of amendment. We would be pleased to work with your staff on drafting it. Unless it is coupled with a restriction on control, we still would prefer the bill not be passed.

Senator STEVENSON. My time has expired. I would just point out if there is concern on the part of anyone, all they have to do is deny the application and prevent the bank from making the investment—that is not a question.

The CHAIRMAN. I just have one more question, Mr. Wallich, export trading company legislation would permit not only bank holding companies to own trading companies, but also permit national and State banks to own them. It has been said that Congress is interfering in States' rights by giving State-chartered banks affirmative powers. Also that more than one regulatory agency would be involved in interpreting these new provisions.

AMENDMENT WITH LIMITING POWERS

Would the Feds support an amendment limiting powers to own trading companies to bank holding companies as a permissible activity?

Mr. WALLICH. It has the attraction of simplification, Mr. Chairman. There might be a question of whether it would exclude banks that are not affiliated with bank holding companies. One might find as a practical matter that such banks are unlikely to be involved with an export trading company anyway.

Without speaking for the Board, I would say this is an attractive suggestion.

The CHAIRMAN. Mr. Sprague?

Mr. SPRAGUE. Such an amendment would appear to bring in the regional banks that you are looking for, I believe. I am not certain, but I suspect that most of those banks are holding company affiliated. We have not studied such an amendment, but it has the attraction of putting the supervision with the Federal Reserve, which is now heavily involved with related types of activities. At first blush, I would say we think that is attractive. I would like to look at it.

Senator HEINZ. Mr. Chairman, could you repeat your proposed amendment?

The CHAIRMAN. What it is is to confine the ownership of trading companies to bank holding companies. And not banks. In other words, you would not have individual banks—only the bank holding company. Only as a permissible activity. We have a series of permissible activities.

Senator HEINZ. Thank you.

The CHAIRMAN. That is all. Senator Heinz?

Senator HEINZ. I was wondering if Governor Wallich, in particular, but I do not wish to shut Mr. Sprague out, would care to expand on his previous answer to my question, the question of the extent to which the risks are really of any significance to our banking system and to our economy and to our society.

Mr. WALLICH. Well, Senator Heinz, the risks are of several kinds. I believe the major one is the credit and investment risks that the banks could get into here. A second risk is that bank credit might be misallocated as a result of bias or preference that might be generated in favor of an owned——

Senator HEINZ. Why is that a problem? You are talking about individual bank risk. Not societal or overall risk, which is the thrust of my question.

But on that point, since you brought it up, those kinds of bias lending practices are prohibited in the legislation in the same way that existing legislation, which bank regulators are already responsible for enforcing, prohibits insider transactions.

Now, my understanding is that that has been effective. It has not caught everybody, but we have been into some interesting cases in this committee going back about 2 years ago involving Georgia banks and others. I don't see how this can be considered so risky.

We have a prohibited activity and we already have experience in enforcing such prohibitions.

Mr. WALLICH. I think a prohibited activity is very unlikely to be engaged in. We do have a certain amount of experience with arm's-length provisions in various areas.

As I said, arm's-length provisions are easier to administer with respect to terms. One can see through bank examination whether they charged one bank 8 percent and the other bank 10 percent, or the other customer 10 percent. But whether they rejected one and accepted another on such grounds is much less easy to document from examination and may be impossible to document as being bias, because there is always a credit judgment in turning one down and accepting the other, and it may have been on legitimate credit grounds.

I would not put this in the forefront of the argument. The forefront is opening up of very considerable risks.

Senator HEINZ. To individual banks. But almost taking a worst-case senario, the worst-case senario by the way is that our legislation is: A, passed; B, is successful in forming trading companies, that people go out all over the world and trade, that we pay our oil bills not by selling off our factories and banks, such as the Marine Midland Bank to the Hong Kong-Shanghai Bank, which has 329 subsidiaries which engage in nonbanking activities, but that we have trading companies out there taking risks and one or two of them fail, and one or two banks fail, and the country is still tens of billions of dollars a year better off.

Arabs and others own less of the United States, own fewer of our banks.

I mean, what is the nature of this terrible risk relative to the others we impose on you?

Mr. WALLICH. Well, if an export trading company can perform all these miracles——

Senator HEINZ. They are doing it for the Japanese.

Mr. WALLICH. Then I would argue that they can probably accomplish these extraordinary feats even without bank control and with the myriad of banks financing them, lending to them, advising them, and performing other services.

Senator HEINZ. Have you ever known a businessman who could get along without a bank?

Mr. WALLICH. He would have his bank, but not an ownership interest by the bank.

Senator HEINZ. That's not the way they feel. [Laughter.]

Mr. WALLICH. That may be the case.

Senator HEINZ. Thank you, Mr. Chairman. I yield.

The CHAIRMAN. Senator Stevenson?

Senator STEVENSON. I have no more questions.

The CHAIRMAN. Thank you very much, gentlemen.

Mr. WALLICH. Thank you.

The CHAIRMAN. Our next witnesses are Douglas Stucky and Robert McCormick.

Is Mr. Ben Bailey here? Why don't you come forward too. Senator Stevenson would like you to join this panel.

STATEMENTS OF DOUGLAS R. STUCKY, FIRST VICE PRESIDENT, FIRST WISCONSIN NATIONAL BANK, MILWAUKEE, WIS., ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION, ACCOMPANIED BY ANDREW J. VALENTINE, ASSISTANT GENERAL COUNSEL FOR THE NORTHERN TRUST CO., OF CHICAGO; ROBERT L. McCORMICK, PRESIDENT, STILLWATER NATIONAL BANK, STILLWATER, OKLA., ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION; AND BEN BAILEY, VICE PRESIDENT, AMERITRUST CO., CLEVELAND, OHIO, ON BEHALF OF THE BANKERS ASSOCIATION FOR FOREIGN TRADE, ACCOMPANIED BY GARY WELSH, ASSOCIATION COUNSEL

The CHAIRMAN. Before we begin we have two principal witnesses here. Let's go across the table and get everybody identified so maybe we will have questions for all five of you.

Mr. McCORMICK. I am Robert L. McCormick, vice president of the Independent Bankers Association. I have with me Mr. Peterson, general counsel with our western office.

Mr. STUCKY. Doug Stucky with the First Wisconsin National Bank of Milwaukee, representing the American Bankers Association.

The CHAIRMAN. Mr. Stucky, we are honored to have you present. You are one of my bosses in Wisconsin. You are first vice of a remarkably fine bank. We are very proud. Go ahead.

Mr. STUCKY. Thank you. Mr. Chairman and members of the committee, I am Doug Stucky, speaking on behalf of the American Bankers Association. As you well know, the ABA is a trade association with membership comprising over 90 percent of the Nation's 14,500 full-service commercial banks. Mr. Chairman, I would like to request a copy of the ABA's detailed statement be placed in the record.

The CHAIRMAN. Without objection it will be done.

Mr. STUCKY. In the interest of conserving time I would like to present an abbreviated summary of the position.

The CHAIRMAN. We appreciate that. How long is your statement?

Mr. STUCKY. Seven or eight minutes.

I would like to present an abbreviated summary of the ABA position and recommendations vis-a-vis crucial issues related to S. 2718. Hopefully the summary will allow more time for the questions and issues which this committee would like to address informally. Over the years the American Bankers Association has supported numerous programs to expand U.S. exports as part of a larger and essential effort to reduce the Nation's balance-of-trade deficits. The banking industry believes the growth of U.S. exports must warrant the highest priority. Especially in today's increasingly competitive international environment. With the 1979 trade deficit of nearly $25 billion and an even greater one projected for 1980, the need for a much stronger export performance was never greater.

UNITED STATES TRAILS MAJOR INDUSTRIALIZED COUNTRIES

According to 1978 figures from the U.S. Department of Commerce, the United States trails all major industrialized countries when exports are expressed in percent of gross national product. The U.S. share of 6.7 percent compares very unfavorably with

66-942 0 - 80 - 6

Germany at 26 percent, France at 16 percent, South Korea at 27 percent, Italy 44 percent. This is even without looking at the performance of Japan.

According to U.S. Government statistics about 250 firms account for 80 percent of U.S. exports. This means nearly 25,000 other firms account for only about 20 percent of U.S. exports.

One other noteworthy statistic is cited. The Commerce Department estimates that nearly 20,000 other firms, mostly small- or medium-sized enterprises have products that are exportable. Such firms have chosen not to become involved with exporting for several reasons. They are unable to assess or locate overseas markets for their products. They don't have the financial resources to create an independent export department. The complex documentation and regulations to be overcome in consummating an export sale discourage new exporters from seeking underlying business. Prior experience may have been unpleasant or resulted in commercial losses for various reasons. Qualified international personnel are hard to find. Commercial banks for various reasons have been unable to fill the domestic and international credit requirements of smaller firms.

In our opinion, a properly organized and staffed ETC offers a small- and medium-sized exporter the opportunity to overcome many of the referenced problems. While overcoming such problems the ETC also provides a solution at an affordable price reflecting the economy of scale achieved by the larger ETC organization.

Finally the ETC as the international arm or representative of the smaller firm can, in effect, often convert an export order into a domestic sale for cash. The ABA feels the following major elements in S. 2718 are essential to the future success of export trading companies. One area is that of antitrust exemption.

The legislation must provide for prior clearance of activities so ETC's can serve a large number of firms whose products on occasion may directly compete with one another. The legislation should bestow DISC benefits to ETC's, float banking and nonbanking alike, to provide incentives to them to remain in or increase efforts in exporting.

Banks should be permitted on a specific approval basis to have the right to hold controlling investments in ETC's.

COMPETITIVE EQUALITY

Finally, competitive equality. It's imperative that banking organizations compete equitably with other financial service or intermediary organizations. Any restrictions or prohibitions in S. 2718 for bank-related ETC's should be applied equally to all other financial intermediaries to prevent competitive disadvantage.

These elements are more fully addressed in our complete statement.

In summary, Mr. Chairman, by no means do we see the enactment of S. 2718 as a panacea for our export deficiencies but the ABA does feel that this legislation is a much-needed step in the right direction. It's in this spirit that the American Bankers Association strongly support S. 2718 as reported by this committee last May. However, Mr. Chairman, we are fully aware of the concerns raised by you, the Board of Governors, and the Federal Reserve

System and others as they relate to these matters. Should this committee or the Senate in its wisdom seek to restrict bank participation in export trading companies, the American Bankers Association would not oppose such efforts in order that this vital legislation move expeditiously through both houses of Congress.

Because the U.S. banking system reaches virtually every U.S. business including specially small- and medium-sized businesses we must not lose sight of what we are trying to accomplish with this legislation. That is to improve our Nation's export performance by the establishment of export trading companies.

We thank the committee for the opportunity to appear today and will be pleased to answer any questions you may have.

[Complete statement follows:]

TESTIMONY OF

DOUGLAS R. STUCKY

ON BEHALF OF THE

AMERICAN BANKERS ASSOCIATION

Mr. Chairman, and Members of the Committee, I am Douglas R. Stucky, First Vice President of the First Wisconsin National Bank of Milwaukee and a member of the American Bankers Association's International Banking Division's Executive Committee. In addition, I served as Chairman of the Task Force assigned to study the Export Trading Company Act of 1980. With me today is Andrew J. Valentine, Assistant General Counsel for the Northern Trust Company of Chicago. The American Bankers Association is a trade association with a membership comprising over 90% of the nation's 14,500 full service banks.

Gentlemen, it has often been said that the "art of the possible" is determined by the will of a country's political leaders. Never has there been a time when the need for the United states to export its high quality goods and services than today. Yet what is today's story when you look at the percent of GNP represented by exports of the United States versus other industrialized countries of the world. The following statistics are cited to emphasize the relative performance of the U.S. by measuring exports as a percent of GNP:

*Country	Percentage
Japan	97%
West Germany	26%
France	16.7%
South Korea	26.8%
Taiwan	44.1%
Italy	44.6%
U.S.	6.7%

*Source: Office of Trade Statistics, U.S. Department of Commerce

While the relative trends and commitments to exporting by U.S. firms has been improving in the last few years, it is not sufficiently favorable to correct the nation's persistent trade and payments deficit. The ABA is pleased to be invited to testify on S. 2718 to strongly enforce the absolute need for the Congress to show the political will to stimulate the export performance of our nation.

The ABA testimony will attempt to address the following issues:

(1) Do small and medium-sized firms actively participate in the U.S. exporting effort? Why or why not?

(2) What are the essential elements (i.e., antitrust, tax, financing, etc.) that must be included in S. 2718?

(3) Why it is prudent and necessary for banking organizations to have the right to have equity positions (possibly up to 100%) or control of export trading companies (ETC's).

(4) Competitive equality for firms, both commercial and financial intermediaries, and banking organizations, that elect to form export trading companies.

The Participation of Smaller Firms in Exporting

It is estimated that of the 250,000 business organizations in the United States only about 25,000 directly engage in the sale of their goods and services in overseas markets. Of the 25,000 organizations that export it is further reported that 250 firms account for 80% of U.S. exports. This would certainly seem to support the conclusion that major corporations tend to dominate or account for the nation's present export performance, and, correspondingly that most other firms -- regardless of size -- are either not committed to or do not have the expertise to actively participate or seek sales in overseas markets. The non-exporting firms to which I allude are indeed the smaller and medium-sized firms of the United States. The Department of Commerce realistically estimates that at least 20,000 U.S. firms could become exporters -- primarily those of the economic size just mentioned.

Why don't or aren't small and medium-sized firms involved in exporting? The following reasons are cited:

(1) In spite of good efforts and programs by the Department of Commerce, most firms still don't know how to find or assess the size of overseas markets for their products.

(2) They do not have the financial resources or flexibility to staff up for an independent, internal group to seek export business. Or, alternatively, they may choose to allocate their resources to the domestic market where lesser risks are perceived or a better return on available capital can be obtained.

(3) The documentation required for export sales, the labyrinth of U.S. and foreign regulations that must be contended or complied with, the longer cash flow cycle related to the conclusion of most export orders, and other concerns, are impediments for a businessman trying to decide whether his firm should actively, on an on-going basis, seek sales in offshore markets.

(4) Limited -- but prior -- experience with an export order has been unpleasant or resulted in a potential or real business loss -- possibly because the firm did not seek or could not obtain good advice on how to control or minimize the various risks involved in an export sale.

(5) Qualified personnel often cannot be obtained to establish a full-fledged export department within the existing wage and salary policies of a corporation.

(6) Commercial banks, for various reasons, are not able or prepared to provide facilities to support all the credit needs that a corporation has for both domestic and export sales.

No doubt you could cite other valid reasons besides those just mentioned. In our opinion, a properly organized and staffed ETC offers the smaller exporter the opportunity to overcome the above problems, but yet allows it to gain the "economy of scale" benefits of a larger organization (the ETC) at an affordable price, while transferring or minimizing most of the risks to an export order to an ETC who is experienced and prepared to assume the related political and commercial risks of an overseas sale. In effect, the ETC has the ability to convert an export order to the equivalent of a domestic sale for the smaller firm.

Essential Elements for Incorporation into S. 2718

The preamble of S. 2718 effectively highlights the needs and reasons why U.S. firms, both financial and non-financial, should be allowed and openly encouraged to form ETC's. The ABA strongly supports the needs and commerical justification for forming trading companies. In our opinion, the following areas of th proposed legislation are critical to the improved export performance of our nation and to the success of ETC's which are formed:

(1) Antitrust Exemption

It is realistic to assume that successful ETC's will and must deal with numerous smaller firms that have products which in most cases will be complementary but in isolated cases may be competitive. This competitive aspect should not be magnified out of proportion, because there are natural factors in the marketplace, that limit the practical reality of an ETC being able to control or monopolize the smaller firm. Most foreign buyers make the actual purchase decision and will not delegate such this role to a little-known ETC. Additionally, the ETC sales respresentative does not understand the technical qualities of a product as well as the user. Finally, one must not overlook the very real fact that most products -- especially capital goods -- are produced by multiple manufacturers in both the U.S. and foreign countries. This virtually assures that the competitive, global marketplace will provide an effective counterbalance to the limited, but logical antitrust exemption that an ETC requries to properly represent sizable numbers of smaller firms, some of which may, on occasion, be competing for the same foreign order. We feel that the bill, as proposed, has adequate controls to punish any firms which might intentionally violate the spirit of the antitrust provisions of the bill.

(2) DISC Treatment or Benefits for ETC's

We beleive that existing DISC corporations have been a positive factor in the improving trade position of the United States in spite of the fact that a major portion of the tax-deferred benefits have subsequently been removed from the Tax Code. While it is indeed difficult to document specific examples -- in writing -- a good number of our member banks have informally shared comments made to them by smaller exporters that DISC treatment was instrumental in their entering the market for overseas business, or caused them to make a broader commitment to the export market. Smaller business would recognize that the provision of DISC benefits to an ETC are a tangible and meaningful statement from the federal government that the participation of smaller firms is to be encouraged as a matter of national priority. DISC treatment has the additional benefit of temporarily broadening the equity position of smaller firms thus possibly enabling them to obtain enhanced credit facilities from the banking community. DISC benefits probably represent the most obvious and direct evidence to the smaller businessman of the profits that can be earned by exporting one's products. We believe that the aggregate revenue loses that the government would foregc by bestowing DISC benefits to ETC's is modest in relationship to the "export attitude" that would be created in the minds of the business community. We are convinced that the ultimate result of DISC benefits for ETC's will, over the long-term, be improved trade results, greater tax revenue, and greater overall employment for our nation. For these reasons we are extremely supportive of the DISC language in S. 2718.

Bank Equtiy Participation

Mr. Chairman, the ABA is aware of the concerns you, this Committee, the federal banking agencies, and other parties have expressed on the issue of controlling interests by a commercial bank in an ETC. Our member banks are just as concerned as this Committee to avoid the problems that some banks have encountered in their REIT ventures, foreign exchange dealings, and other similar experiences in the areas of banking. We also want the legislation to provide reasonable controls or safeguards that would prevent the occurrence of similar difficulties in the activities of bank-controlled export trading companies.

Initially, we wish to declare our position that the American Bankers Association strongly supports the position of the right to banks having controlling interests in Export Trading Companies. We intend to look at this position from the following viewpoints:

(a) The implied responsibilities of non-controlled investments by banks.

(b) Safeguards, through statutory language, that would clearly spell out those activities in which ETC's with controlling bank ownership would be excluded from conducting or arranging through such firms.

(c) Structural forms in which bank-controlled ETC's might operate.

(d) The analysis of risks inherent to ETC's and whether such risks need unfavorably impact on a bank or bank holding company.

It is our conviction that the legislation should recognize that while the ETC concept is well-known around the world but totally new to the United States. Thus, final language should provide for flexibility to allow for the concept to develop in this country in line with actual experience of ETC's, the evolving role ETC's will logically play in a changing world of the future, and provide for administrative freedom to modify permitted activities and roles for an ETC without having to pass amendatory language each time a change is agreed upon by the requisite federal authorities.

Non-Controlled Investment by Banks

Many commercial banks regardless of size or location, have had unfavorable experiences with investments in banking affiliates wherein they have had a minority and non-controlling equity position. This results from the fact that a bank is often -- in such situations -- not in a position to preclude such activities that it considers unsound simply because it does not have either voting or management control of an affiliate. No matter what public declarations are made the parent bank is unable to avoid the implied responsibilities that go with any investment made by a bank in a non-controlled affiliate. Thus, the rationale is adopted that if implied financial responsibility attaches to a bank -- reagardless of ownership position -- then bank management will undoubtedly decide to invest in firms where it has equal responsibility and ownership positions.

Not all commercial banks will want controlling ownership rights in an ETC firm for reasons of policy or philosophy best known to them -- but this should not preclude other banks from being allowed controlling positions in such enterprises. We believe that controlling positions are best processed on a specific application approval basis by the appropriate Federal banking agencies. This is in line with the present language and controls of S. 2718.

Statutory Safeguards

A review of S. 2718 might indicate that the language may be too general or liberal in a couple of specific areas. Mr. Chairman, it is not the intent -- as assessed from the ABA Trading Company Task Force or discussions held at a very recent Government Relations Council meeting -- of bank-related ETC's to use such enterprises to become securities dealers or underwriters nor to become commodity traders. Thus, if this Committee feels that certain activities or functions of ETC's should be specifically probihited in the legislation, we would not, oppose such modifications. Of course, we would be prepared to help you review or evaluate a list of specific exclusions which are deemed appropriate.

Some discussion has also evolved around the meaning of the term "principally engaged" as it relates to ETC's. We would hope that any attempt at defining such term would include language that would allow an ETC to be involved in the exportation or importation of products, or for that matter, permit an ETC to be formed to carry out project-type activities for a limited period of time. While the emphasis on exporting activities must predominate, it is realistic to recognize that an ETC can fill a useful role by also handling the importing needs of an existing client as well. From the ETC management viewpoint, it allows them to better rationalize its staff, its fixed assets, and its distribution network, if allowed to serve both the exporting and importing needs of a client. No doubt such additional activities -- without undue risk -- could also enhance the operating profits and financial substance of an ETC.

From a client standpoint it is advantageous to (a) have "one-stop" shopping for both export and import activities, and, (b) the cost benefits of scale purchases by an ETC,.and, (c) relief from credit facilities of a client at his local bank, and, (d) assured compliance with trading regulations and documentation for both buyer and seller.

Structure of Export Trading Companies

ETC's will be formed in many different ways to capitalize on the ingenuity of different management philosophies of both financial and non-financial corporations. This is sound and appropriate because it allows changing trading customs and patterns to be accommodated by capable marketers in the global environment. The final language of S. 2718 should attempt to capture this needed flexibility so as not to inhibit the growth and success of the broad ETC concept as employed by U.S.-based firms.

Some banks, with large international branch networks and/or trade services arms, will wish to have wholly-owned ETC subsidiaries to best serve the needs of their existing or potential export clients. This form could result in better risk minimization and more efficient banking systems or forms for both the ETC and the client.

In a different part of the ETC spectrum, other banks -- probably the regionals -- may wish to enter into joint venture ETC's with other banks or with certain customers of the bank. The idea of including an existing customer in a joint venture would be to tap the superior marketing or technical skills of a firm that is already highly sophisticated in handling international business. Let it be said that it may be advantageous -- in joint venture or consortium arrangement -- to have both U.S. or foreign partners that can contribute their own special skills and contacts to an ETC. The foreign partners could and should be both banking and/or non-banking partners.

Similarly, it is not unrealistic to assume that private companies, such as grain dealers, could be very successful ETC's. They probably have excellent contacts with foreign government officials who make sizable purchase commitments on behalf of their nation. Consumable goods would logically and conveniently be best sold through such ETC related firms. Finally, capital goods manufacturers, who have existing dealer networks spanning the globe in many countries, could very logically form an ETC that would purchase and sell accessory or complementary products used by local buyers of the basic capital goods produced by such multinational firms. Such multinational firms could choose to form an ETC as a wholly-owned subsidiary, or, a joint venture with U.S. and/or foreign partners.

It is clear to us that the importance of the early passage of ETC legislation is more important than the fact that it describes the approved organization structure that an ETC might have. The longer it takes to pass S. 2718 the greater time it allows traders in other countries to lock up new markets or better marketshare in existing territories. The job of exporting is now not later.

Risks Inherent to ETC's

Prior testimony before Senator Stevenson's Subcommittee on ETC's has adequately addressed most of the risks, or such issues may be addressed by other witnesses appearing today. We have thus purposely chosen not to duplicate such efforts.

In summary, Mr. Chairman, by no means do we see the enactment of S. 2718 as a panacea for our export deficiencies, but the ABA does feel that this legislation is a much needed step in the right direction. It is in this spirit that the American Bankers Association strongly supports S. 2718, as reported by this Committee last May. However, Mr. Chairman, we fully recognize the concerns raised by you, the Board of Govenors of the Federal Reserve System, and others as they pertain to equity participation of banks in export trading companies. Should this Committee or the Senate, in its wisdom, seek to restrict bank participation in Export Trading Companies, the American Bankers Association would support such efforts in order that this vital legislation may move expeditiously through both Houses of Congress. Because the U.S. banking system reaches virtually every U.S. business, including especially small and medium-sized businesses, we must not lose sight of what we are trying to accomplish with this legislation and that is to improve our nations export performance by the establishment of export trading companies.

We thank the Committee for the opportunity to appear today and we would be pleased to answer any questions you might have.

The CHAIRMAN. Thank you. Mr. McCormick.

Mr. MCCORMICK. I am Robert L. McCormick, second vice president of the Independent Bankers Association of America (IBAA) and president of the Stillwater National Bank & Trust Co., Stillwater, Okla. I appreciate this opportunity to present to this committee IBAA's current observations on S. 2718, the Export Trading Company Act of 1980.

I cannot say to you today that the association has ever formally considered the specifics of S. 2718 or any of its predecessor versions or legislative relatives. This is not because the association has been unaware of such legislation, its content, or its impact. Rather, it is because, due to the slight direct export involvement of our affiliates, it has been considered inappropriate to devote considerable association resources to this subject. My undertaking today is simply to analyze how the traditional philosophies of the IBAA square with S. 2718.

First, we are strong supporters of improved American exports if on no other grounds than that they benefit the general welfare of the Nation. While most IBAA members, as previously noted, are not immediately involved in international business, the association does monitor its conditions because so many of our constitutents finance agricultural production, the health of which is increasingly dependent on strong overseas commodities vending. We have noted with special pleasure that over the past 2 years exports have increased 50 percent in value and 20 percent in volume, with strong performances in both agricultural and manufactured goods although we also realize that a substantial reason for this improvement is the depreciation of the value of the dollar in terms of foreign exchange.

Difficulties often appear in reconciling one's broad views when it comes to adopting a position on specific statutory proposals. The Export Trading Company Act of 1980 presents a classic example of this for the IBAA. The bill would seem to be a definite plus for foreign trade. On the other hand, the association has also been philosophically opposed to trends which would erode the general policy of the separation of depository banking activities from other forms of commerce that has been imbedded in the legal system since passage of the Banking Act of 1933. S. 2718 certainly moves toward such erosion since it permits nearly any kind of a commercial bank, bank holding company, Edge Act, or agreement corporation—defined there as "banking organizations"—to acquire substantial equity positions in companies which are organized principally for the purpose of exporting goods or services produced in the United States or facilitating their export.

BREACHING OF THE BANKING ACT OF 1933

The safety and soundness issue: IBAA believes that the breaching of the Banking Act of 1933, will again lead the country into a commercial banking system prone to unsound, imprudent, and excessively speculative investments, as was the case in the early 1930's. We note that most of the variations on, or exceptions to, the standards of the 1933 act, as amended, are limited.

The Bank Holding Company Act of 1956, as amended, reiterated the basic notion of separating depository banking from other forms of commerce. The records of passage of the 1966 amendments to the Bank Holding Company Act clearly indicate that the Congress wished to continue the division as a device for insuring the safety and soundness of the depository banking system. The National Legislature, however, did permit some flexibility; namely, that bank holding companies can hold the shares of firms whose activities could be engaged in by commercial banks themselves, or whose activities are of a financial, fiduciary, or insurance nature and are, in the view of the Federal Reserve Board, so closely related to depository banking as to be an appropriate incident thereto.

S. 2718 contains a number of restraints on the amount and type of speculative risks to which banking organizations could expose themselves. To a considerable degree, these protect the depository banking system from drifting into areas of instability, such as these banks encountered in real estate investment trusts. If the Congress does decide to blur the line separating commerce and depository banking regarding exports, it could be appropriate to impose one further safety and soundness limit on export trading companies (ETC's) in which banks have substantial interests. This would be a statutory guide for bank regulatory authorities of an inventory-to-capital ratio, using the trading company's capital as the base, for those circumstances in which the trading company takes title to goods in without having orders to resell them.

A second consideration in IBAA's longstanding support for the general approach of the Banking Act of 1933, as amended, and its reiteration in the Bank Holding Company Act of 1956, as amended, is that dividing the essentials of depository banking from other forms of commerce has prevented concentration of economic power in ever fewer firms. It is a common apprehension that if commercial banks could range into other commercial areas, their access to funds through deposits would eventually allow them enough leverage to control a high percentage of enterprise in the United States. This is especially true of the so-called megabanks. The association, therefore, finds disturbing comparisons in the committee's report on S. 2718 between the success of European, Japanese, and Korean trading companies and the inadequacies of the U.S. environment. On that continent and in those countries, economic power is, indeed, concentrated in the hands of a restricted number of consortiums of merchant banks, depository banks, investment banks, and trading companies.

Additionally, I would like to note that economic concentration seems to us very much on the rise in the United States. Ironically, it is moving forward under the guise of deregulation and increased competitive ability, both of which have been claimed to be some of the virtues of S. 2718. Deregulation has meant consolidation in the securities business, with the advent of negotiated rates and mergers in the airline industry.

Within months of passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, we can already see an increase in acquisitions—sometimes by foreign sources—and mergers in the depository industry, with the savings and loan sector being particularly prominent. Special care seems warranted to avoid a further drift toward economic concentration as the regulatory apparatus—which has been an effective substitute in highly regulated areas for the general, domestic, and woefully inadequate antitrust laws—is altered.

In short, while Europe, Japan, and Korea might have accomplished some very admirable achievements in the field of exports, our attempts to parallel their successes should not sacrifice dispensed economic decisionmaking or otherwise unwisely facilitate the mounting trend toward economic concentration.

If the Congress decides to enact S. 2718, IBAA believes the following modifications might help alleviate the potential for undue concentration of economic power.

SUGGESTED MODIFICATIONS

First, export trading companies in which banks have a substantial interest could be statutorily embargoed from engaging in the actual manufacture of goods; from speculating in securities, as S. 2718 even now would prevent them from speculating in commodities; and from entering into agribusiness production. We understand that such export trading companies, under S. 2718, are limited principally to the export business, but additional direct and specific prohibitions in these areas might be advisable in order to remove the possibility of them pushing into these fields.

Further, the suggestion of the Federal Deposit Insurance Corporation contained in its letter to Senator Stevenson of June 27, 1980, to the effect that the word "principally," as it appears at sections 103(a)(5) and 105(a)(13) should be defined, seems meritorious. The Corporation's letter advised the insertion of a definition of "principally" which would specify that some percentage of gross or net earnings of an ETC would have to relate directly to the export or the facilitation of the export of U.S. goods and services before a company could qualify as an export trading company, open to banking organization equity ownership. Such a provision would guard against ETC's ranging from the stated focus of the act, which is to improve exports.

An additional improvement in the legislation to hedge against concentration of economic power in a few megabanks would be to amend the definition of "bankers bank" as it appears on page 7, line 5 of the reported bill. A bankers bank is essentially a joint venture of many independent banks which allows them to compete better in numerous markets against large banking entities. As we watch bankers banks evolve, few of them will be organized "solely to do business with other financial institutions," a requirement of S. 2718.

The language of S. 2718 is drawn from the "exemption" which appears as the next-to-the-last clause of section 103 of the Depository Institutions Deregulation and Monetary Control Act of 1980. It was used there for a very specific purpose related to reserve innovations. A more appropriate set of standards defining a bankers bank appears at section 711 of the same public statute.

As they are now developing, bankers banks will be servicing some of the needs of the officers, directors, or employees of the many banks owning the bankers banks, especially with respect to bank stock loans.

The officers of the association feel that several supplementary limitations on the ownership structure of export trading companies might be suitable. First, any investment made by a banking organization in an export trading company could be subject to the approval of the appropriate Federal banking agency. Presently, S. 2718 allows investments up to $10 million without approval unless the relevant agency finds that the investment renders the ETC a subsidiary of the banking organization.

Due to the novelty of joining depository banking and export trade in the manner contemplated by S. 2718, we believe such a limitation would be advisable. Second, it might be proper to prevent a single banking organization from owning more than 20 percent of an export trading company. This prohibition would help diffuse ownership interest if not actual control of such firms among a number of banking organizations and prevent dominance by a few large banking organizations of the ETC field.

Our final problem with the bill itself is that, by virtue of section 105(a), it amends the charters of State banks by Federal statute. While it is common practice to place limitations on what State banks can do by Federal law—for example, ceilings on interest rates of time and savings funds—it is not common for the National Legislature to extend to State banks new privileges, especially where they are prohibited by express State statute, as would often be the case with equity ownership in ETC's. The association has traditionally opposed such actions by the Federal Government. The drift toward complete regulatory control of the commercial banking system in Washington has been accelerating and will be further accelerated by S. 2718.

For these reasons, general policy directives of many national IBAA conventions upholding the dual banking system must be interpreted as reservations against setting this precedent with regard to State banks via S. 2718, reservations shared with the FDIC as evidenced by its letter to Senator Stevenson.

In closing, I would like to note our regret that the tax features of the legislation will not receive additional consideration during this Congress. Expanded exploration of the use of tax incentives to promote exports before the Committees on Ways and Means and Finance could well reveal that the most productive method for spurring the formation of export trading companies is not to alter the traditional separation of depository banking and other forms of commerce. Rather, it could well be to establish such strong tax motivations that other-than-banking entrepreneurs would be drawn into the export trading scene. If S. 2718 should fail to become law during this Congress, one would hope that the tax alternative gets a full analysis in both chambers in 1981.

I thank the committee for the opportunity to appear, ask that this entire written statement be included in the record, and will be pleased to attempt to answer any questions.

The CHAIRMAN. Without objection, it will be put in the record.

[The complete statement follows:]

STATEMENT

OF THE

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

I am Robert L. McCormick, second vice president of the Independent Bankers Association of America (IBAA) and president of the Stillwater National Bank and Trust Company, Stillwater, Oklahoma. I appreciate this opportunity to present to this Committee IBAA's current observations on S. 2718, the Export Trading Company Act of 1980.

The Association is a trade group comprised of approximately 7300 national and state commercial banks, better than 50% of the total of such institutions in the country. Our typical member ranges in asset size between $15-25 million and is located in a suburban or rural setting. Many in our constituency, nevertheless, are also in urban areas. The emphasis of our firms' business is heavily domestic. Very few have Edge Act affiliates or are otherwise routinely engaged in international markets. Consequently, IBAA cannot claim to bring here a direct expertise on the subject matter of S. 2718, which seeks to strengthen U.S. global trade by facilitating the establishment of exporting companies through permitting U. S. banks to take equity positions in such corporations. Further, I cannot say to you today that the Association has ever formally considered the specifics of S. 2718 or any of its predecessor versions or legislative relatives. This is not because the Association has been unaware of such legislation, its content, or its impact. Rather, it is because, due to the slight direct export involvement of our affiliates, it has been considered inappropriate to devote considerable Association resources to this subject. My undertaking today is simply to analyze how the traditional philosophies of the IBAA square with S. 2718.

First, we are strong supporters of improved American exports if on no other grounds than that they benefit the general welfare of the nation. While most IBAA members, as previously noted, are not immediately involved in international business, the Association does monitor its conditions because so many of our constituents finance agricultural production, the health of which is increasingly dependent on strong overseas commodities vending. We have noted with special pleasure that over the past two years exports have increased 50 percent in value and 20 percent in volume, with strong performances in both agricultural and manufactured goods although we also realize that a substantial reason for this improvement is the depreciation of the value of the dollar in terms of foreign exchange.

Last month, I testified before you with respect to H. R. 4758, a version of the Farm Credit Act Amendments of 1980, which, after a thorough and formal review, the Association endorsed. Portions of that legislation would substantially enhance the ability of the 13 Banks for Cooperatives of the Farm Credit System to augment U. S. agricultural exports, meaning possible further encroachment of these tax exempt entities into rural banking markets. Our endorsement of H.R. 4758, however, was based in part on the Association's belief that foreign agricultural sales must be increased. This was consonant with the action of our last convention in April of this year which, in its Resolution F, stated:

> "With our nation's agricultural plant nearing full production capacity, it is mandatory that a high priority be placed on using markets outside this country for agricultural production which otherwise will become surplus. The inability to export farm products will not only have an adverse effect on this country's balance of trade but will also create financial difficulties for the nation's farmers."

I mention my appearance last month, our endorsement of H.R. 4758, and Resolution F not because they directly address the major issues raised by S. 2718 but to underscore IBAA's fundamental commitment to improved exports.

Difficulties often appear in reconciling one's broad views when it comes to adopting a position on specific statutory proposals. The Export Trading Company Act of 1980 presents a classic example of this for the IBAA. The bill would seem to be a definite plus for foreign trade. On the other hand, the Association has also been philosophically opposed to trends which would erode the general policy of the separation of depository banking activities from other forms of commerce that has been imbedded in the legal system since passage of the Banking Act of 1933. S. 2718 certainly moves in such a direction since it permits nearly any kind of a commercial bank, bank holding company, Edge Act, or Agreement Corporation (defined there as "banking organizations") to acquire substantial equity positions in companies which are organized principally for the purpose of exporting goods or services produced in the U. S. or facilitating their export.

The Safety and Soundness Issue

IBAA believes that the breaching of the Banking Act of 1933 will again lead the country into a commercial banking system prone to unsound, imprudent, and excessively speculative investments, as was the case in the early 1930s. We note that most of the variations on, or exceptions to, the standards of the 1933 Act, as amended, are limited. For example, national banks can invest, to one degree or another, in the shares of Edge Act and Agreement Corporations, safe deposit companies, bank premise companies, the Federal National Mortgage Association, the Student Loan Marketing

Association, the Government National Mortgage Association, small business investment companies, bank service corporations, foreign banks, Title IX firms created by the Housing Act of 1968, state housing corporations, agricultural credit corporations, community development corporations, and minbank capital corporations. State banks are similarly limited by state codes.

The Bank Holding Company Act of 1956, as amended, reiterated the basic notion of separating depository banking from other forms of commerce. The records of passage of the 1966 amendments to the Bank Holding Company Act clearly indicate that the Congress wished to continue the division as a device for insuring the safety and soundness of the depository banking system. The national legislature, however, did permit some flexibility, namely, that bank holding companies can hold the shares of firms whose activities could be engaged in by commercial banks themselves; or whose activities are of a financial, fiduciary, or insurance nature and are, in the view of the Federal Reserve Board, so closely related to depository banking as to be appropriate.

As far as the "closely related" firms in which bank holding companies can invest, the Federal Reserve has developed an extremely lengthy list which is set out in its

Regulation Y and which ranges from the obviously permissible, such as loan service corporations, to the more ambiguous, such as certain kinds of courier services. It should be noted that a bank holding company may, under an additional exemption to the 1966 Amendments, retain a passive investment up to 5% of the voting stock of <u>any</u> company. Yet, even given all these dispensations, and some more limited and technical ones which appear in the Bank Holding Company Act of 1956, that statute still upholds the basic posture of separating depository banking from other forms of commerce.

S. 2718 contains a number of restraints on the amount and type of speculative risks to which "banking organizations" could expose themselves. To a considerable degree, these protect the depository banking system from drifting into areas of instability, such as these banks encountered in real estate investment trusts. If the Congress does decide to blur the line separating commerce and depository banking regarding exports, it could be appropriate to impose one further "safety and soundness" limit on export trading companies (ETCs) in which banks have substantial interests. This would be a statutory guide for bank regulatory authorities of an inventory-to-capital ratio, using the trading company's capital as the base, for those circumstances in which the trading company takes title to goods in without having orders to resell them. Such a standard would clearly install a Congressional policy against an ETC entangling itself in inventory speculation which might have an adverse impact on the banking organization. Nothing should prevent the bank regulatory agencies from imposing stricter standards on a case by case basis, however.

The Concentration Of Economic Power Issue

A second consideration in IBAA's longstanding support for the general approach of the Banking Act of 1933, as amended, and its reiteration in the Bank Holding Company Act of 1956, as amended, is that dividing the essentials of depository banking from other forms of commerce has prevented concentration of economic power in ever fewer firms. It is a common apprehension that if commercial banks could range into other commercial areas, their access to funds through deposits would eventually allow them enough leverage to control a high percentage of enterprise in the United States. This is especially true of the so-called megabanks. The Association, therefore, finds disturbing comparisons in the Committee's report on S. 2718 between the "success" of European, Japanese, and Korean trading companies and the inadequacies of the U. S. environment. On that continent and in those countries, economic power is, indeed, concentrated in the hands of a restricted number of consortiums of merchant banks, depository banks, investment banks, and trading companies.

Additionally, I would like to note that economic concentration seems to us very much on the rise in the United States. Ironically, it is moving forward under the guise of "deregulation" and "increased competitive ability," both of which have been claimed to be some of the virtues of S. 2718. Deregulation has meant consolidation in the securities business, with the advent of negotiated rates and mergers in the airline industry. Within months of passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, we can already see an increase in acquisitions--sometimes by foreign sources--and mergers in the depository industry, with the savings and loan sector being particularly prominent. Special care seems warranted to avoid a further drift toward economic concentration as the regulatory apparatus which has been an effective substitute in highly regulated areas for the general, domestic, and woefully inadequate antitrust laws is altered. In short, while Europe, Japan, and Korea might have accomplished some very admirable achievements in the field of exports, our attempts to parallel their successes should not sacrifice economic decision making or otherwise unwisely facilitate the mounting trend toward economic concentration.

If the Congress decides to enact S. 2718, IBAA believes following modifications might help alleviate the potential for undue concentration of economic power. First, export trading companies in which banks have a substantial interest could be statutorily embargoed from engaging in the actual manufacture of goods; from speculating in securities, as S. 2718 even now would prevent them from speculating in commodities; and from entering into agribusiness production. We understand that such export trading companies, under S. 2718, are limited principally to the export business, but additional direct and specific prohibitions in these areas might be advisable in order to remove the possibility of them pushing into these fields. Further, the suggestion of the Federal Deposit Insurance Corporation contained in its letter to Senator Stevenson of June 27, 1980, to the effect that the word "principally," as it appears at Sections 103(a)(5 and 105(a)(13) should be defined, seems meritorious. The Corporation's letter advised the insertion of a definition of "principally" which would specify that some percentage of gross or net earnings of an ETC would have to relate directly to the export or the facilitation of the export of U. S. goods and services before a company could qualify as an export trading company, open to banking organization equity ownership. Such a provision would guard against ETCs ranging from the stated focus of the Act, which is to improve exports, and ETCs serving as a vehicle for depository banking organizations to concentrate inordinate economic power.

An additional improvement in the legislation to hedge against concentration of economic power in a few megabanks would be to amend the definition of "bankers' bank" as it appears on page 7, line 5 of the reported bill. A bankers' bank is essentially a joint venture of many independent banks which allows them to compete better in numerous markets against large banking entities. As we watch bankers' banks evolve, few of them will be organized "solely to do business _with other financial institutions_," a requirement of S. 2718. The language of S. 2718 is drawn from the "EXEMPTION" which appears as the next-to-the-last clause of Section 103 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (H.R. 4986). It was used there for a very specific purpose related to reserve innovations. A more appropriate set of standards defining a bankers' bank appears at Section 711 of the same public statute. There it means:

> ...a bank insured by the Federal Deposit Insurance Corporation if the stock of such bank is owned exclusively by other banks (except to the extent State law requires directors qualifying shares) and if such bank is engaged exclusively in providing banking services for other banks

> and their officers, directors, or employees, but in no event shall the total amount of such stock held by associations [substitute: "other banks"] exceed at any time 10 per centum of its capital stock and paid in an unimpaired surplus and in no event shall the purchase of such stock result in the association [substitute: "other banks"] acquiring more than 5 per centum of any class of voting securities of such bank." (Substitutions supplied to apply to all banks and not merely national associations).

As they are now developing, bankers' banks will be servicing some of the needs of the officers, directors, or employees of the many banks owning the bankers' banks, especially with respect to bank stock loans. In other words, when the owners of Bank X wish to sell Bank X to their officers, directors, or employees, the bankers' bank, in which the Bank X holds shares, can make the loan to buy Bank X to such individuals rather than these individuals having to turn to a large money center correspondent for the funds. Consequently, for S. 2718 to have much usefulness to bankers' banks as they are emerging in the real world, it would be preferable if the Export Trading Company Act tracked Section 711 of H.R. 4986. If bankers' banks in S. 2718 are more realistically defined along the "true to life" lines of Section 711, the ability of bankers' banks to enter the export trading field and also to service their small owning banks' needs for export expertise could then provide a hedge against the possibility that the area will be preempted by a few megabanks.

The officers of the Association feel that several supplementary limitations on the ownership structure of export trading companies might be suitable. First, any investment made by a banking organization in an export trading company could be subject to the approval of the appropriate Federal banking agency. Presently, S. 2718 allows investments up to $10,000,000 without approval unless the relevant agency finds that the investment renders the ETC a subsidiary of the banking organization. Due to the novelty of joining depository banking and export trade in the manner contemplated by S. 2718, we believe such a limitation would be advisable. Second, it might be proper to prevent a single banking organization from owning more than 20% of an export trading company. This prohibition would help diffuse ownership interest if not actual control, of such firms among a number of banking organizations and prevent dominance by a few large banking organizations of the ETC field.

With regard to the administration of the legislation, Section 105(b) stipulates that the appropriate Federal banking agency act within 60 days on written notice from a banking organization of its intentions to make additional investments or to undertake certain activities--most notably the taking of title to goods--by export trading companies.

It also compels the agency to act within 90 days on notice by a bank organization of intention to make an investment of more than $10 million or to assume a controlling interest in an export trading company. If the regulator fails to act within the time limits, the applications would be deeply approved. Again, due to the uniqueness of the approach that S. 2718 takes to export trade and depository banking, it might be sounder to lengthen all approval periods. The Federal Deposit Insurance Corporation, in its letter of June 23, 1980, to Senator Stevenson, suggested 120 days would be sufficient.

Our final problem with the bill itself is that, by virtue of Section 105(a), it amends the charters of state banks by Federal statute. While it is common practice to place limitations on what state banks can do by Federal law (e.g., ceilings on interest rates of time and savings funds), it is not common for the national legislature to extend to state banks new privileges, especially where they are prohibited by express state statute, as would often be the case with equity ownership in ETCs. The Association has traditionally opposed such actions by the Federal government. The drift toward complete regulatory control of the commercial banking system in Washington has been accelerating and will be further accelerated by S. 2718. For these reasons, general policy directives of many national IBAA conventions upholding the dual banking system have expressed reservations against setting this precedent with regard to state banks via S. 2718, reservations shared with the FDIC as evidenced by its letter to Senator Stevenson.

In closing, I would like to note our regret that the tax features of the legislation will not receive additional consideration during this Congress. Expanded exploration of the use of tax incentives to promote exports before the Committees on Ways and Means and Finance could well reveal that the most productive method for spurring the formation of export trading comjanies is not to alter the traditional separation of depository banking and other forms of commerce, Rather, if could well be to establish such strong tax motivations that other-than-banking entrepreneurs would be drawn into the export trading scene. If S. 2718 should fail to become law during this Congress, one would hope that the tax alternative gets a full analysis in both chambers in 1981.

I thank the Committee for the opportunity to appear, ask that this entire written statement be included in the record, and will be pleased to attempt to answer any questions.

# # #

The CHAIRMAN. Thank you, Mr. Bailey.

STATEMENT OF BEN BAILEY, BANKERS ASSSOCIATION FOR FOREIGN TRADE; ACCOMPANIED BY GARY M. WELSH

Mr. BAILEY. Mr. Chairman and members of the committee: I would appreciate it if my full statement is included in the record. My name is Ben Bailey and I am a director of the Bankers' Association for Foreign Trade and chairman of its task force on export expansion. I am also vice president of the AmeriTrust Co. of Cleveland, Ohio's largest bank. I am accompanied today by the association's counsel, Gary M. Welsh, of the Washington law firm of Prather, Seeger, Doolittle, & Farmer.

BAFT is pleased to have this opportunity to express its strong support for passage this year of S. 2718, the Export Trading Company Act of 1980. We perceive from your statement announcing these hearings, Mr. Chairman, that a number of concerns, and we believe misconceptions, remain about the purpose and scope of bank participation in export trading companies (ETC's). In this light, I believe it would be most helpful to you and other members of the committee if I discussed the ways banking organizations might choose to participate in ETC's, and then addressed the major concerns that have been raised concerning bank equity participation. In particular, I would like to indicate why BAFT believes it is both necessary and appropriate to permit banking organizations to make controlling equity investments in ETC's.

BANK PARTICIPATION IN ETC'S

Ways of bank participation in ETC's. S. 2718 does not dictate any particular form of banking organization involvement in ETC's, and we believe this is the best legislative approach to take. We agree with you, Mr. Chairman, that it would be inappropriate to adopt a Japanese Zaibatsu model for the U.S. economy and we believe that S. 2718 does not, in fact, adopt this or any other model.

First, I do not believe that S. 2718 is strictly a big or money-center bank bill. Within our membership, we have found keen interest in this bill among many regional banks. This is not surprising, since these banks serve areas that principally contain the literally thousands of small and medium-sized businesses that could be producing for export, but are not.

Second, I do not believe that this legislation encourages combinations of large banks with large manufacturers. The large manufacturer does not need an export trading company to introduce its products to the world market. It is already there.

What we do see from our discussions in the banking community is a number of possibilities for bank participation which can be as varied as our banking system and economy.

Some regional banking organizations may join together to form an ETC. For example, S. 2718 permits bankers' banks—banks owned by a number of small banks—to form an ETC. An ETC owned by a number of banks from the same region could provide a significant export stimulus to the area.

An ETC owned by a number of banks from different regions could stimulate the export of goods and services from throughout the country.

66-942 0 - 80 - 8

Some regional banking organizations will prefer to organize and form their own trading companies. The regional bank may form such an ETC to give its smaller customers the one-stop service they need to enter the export market. A regional bank may form such an ETC to assist in facilitating trade with China, eastern Europe, or other areas where barter or so-called counter-trade elements may be required due to the lack of U.S. dollar exchange.

Some regional banking organizations may join with nonbank firms to establish an ETC, either on a permanent or one-shot basis. For example, a banking organization, an architectural firm, a construction company, and a steel fabricator could form a one project ETC to bid on a foreign tender. Or a bank might join with an export management company or freight-forwarder to organize an ETC that would provide an opportunity for the more efficient combination of their essentially complementary services.

Some banking organizations may use the opportunity to integrate and expand the types of trade services they already provide their customers.

I would note, Mr. Chairman, that this list is intended as suggestive only. Nevertheless, I think it is useful because it indicates the wisdom of not foreclosing what may turn out to be valuable options by arbitrary statutory restrictions based on certain levels of control.

THE ZAIBATSU CONCERN

We believe it clear from our discussion within BAFT and the banking industry that banking organizations interested in this legislation view it solely as a means for expanding the types of international trade services they can provide to U.S. business in order to promote U.S. exports, and not as a means for investing in or combining with U.S. business in contravention of our basic policies separating domestic banking and commerce.

First, S. 2718 only permits banking organizations to invest in ETC's, and limits any such investments to 5 percent of the banking organization's capital and surplus. An ETC must be principally engaged in exporting and facilitating the exportation of goods and services produced in the United States by unaffiliated persons. Nevertheless, we recognize your concern and the concern of other industry groups that the literal definition in section 103(a)(5) could theoretically permit a bank-owned ETC to engage in non-export/import domestic businesses—for example, the securities business. While we believe the bank regulatory agencies would use their authority under S. 2718 to prohibit such an extension of ETC activities beyond those intended by Congress, we believe language can be included in S. 2718 making this clear for bank-controlled ETC's.

Second, the strict limits on the amount of funds that a banking organization can lend to and invest in a trading company affiliate—a combined limit of 10 percent of its consolidated capital and surplus—insure that a bank-controlled ETC would not have the resources to become a Zaibatsu-like conglomerate even if it had the ability to do so—which, as pointed out above, it does not.

Third, the requirements for antitrust clearance under the Webb-Pomerene provisions and the banking agencies' authority to disapprove any investment over $10 million having adverse competitive considerations insure against any combinations of bank and/or nonbank ownership of an ETC that would have deleterious competitive effects in the United States or on U.S. trade.

I hope, Mr. Chairman, that my discussion has helped to dispel your concerns about S. 2718's possibly suggesting a Zaibatsu model for the U.S. economy. Essentially, S. 2718 permits banking organizations to invest up to 5 percent of their capital and surplus in up to 10 percent of the stock of small business investment companies (SBIC's), among others.

As in the SBIC case, we see no opportunity for a Zaibatsu-like monopolistic potential in our export trade, and believe that legislating on the basis of such unproven concerns, especially in light of the substantial protections already included in S. 2718, would have the principal effect of discouraging bank participation and thus the expansion of small and medium-sized business export.

SAFETY AND SOUNDNESS CONCERNS

S. 2718, as amended by the committee on May 12, 1980, contains comprehensive safeguards that carefully limit and control possible banking organization exposure in export trading company investments.

First, no banking organization, except an Edge Act corporation not engaged in banking, may invest more than 5 percent of its capital and surplus in the stock of one or more ETC's. This is the same limit that currently applies to national bank investments in small business investment companies, and in community development corporations.

Second, no banking organization can in the aggregate and on a consolidated basis invest and lend more than 10 percent of its capital and surplus in or to an ETC. This insures that the financial limitations of section 23(a) of the Federal Reserve Act apply to all banking organization/ETC investments. In contrast, bank-sponsored REITs have always been considered outside the limitations of section 23(a).

Third, the name of an ETC cannot be similar in any respect to that of a banking organization investor. This prohibition insures against public confusion between a banking organization and an ETC affiliate and this avoids the types of problems that arose in the REIT area.

Fourth, a banking organization must terminate its ownership of an ETC if the ETC takes speculative positions in commodities.

Fifth, S. 2718 specifically prohibits a bank from making preferential loans to an ETC in which it has an equity interest, including to any customer of such ETC. The language of the prohibition parallels that in the Financial Institution Regulatory and Interest Rate Control Act of 1978 on insider loans, and is thus a type of prohibition regularly enforced by bank examiners and the bank regulatory agencies.

Sixth, the banking agencies are given clear authority to require divestiture of any ETC investment that may constitute a serious risk to a banking organization investor.

PERMITTING CONTROLLING INVESTMENTS

Reasons for permitting controlling investments by banking organizations. Permitting banking organizations to make controlling investments subject to the limitations included in S. 2718 should not increase risks or potential competitive or conflict of interest problems, but, as indicated in the committee's report (at pp. 10-11), should actually serve to reduce them:

A banking organization with a controlling investment is in a better position to protect its investment and regulate risk exposure. In this regard, if S. 2718 were amended to prohibit controlling investments by banking organizations, it would not in any way change a banking organization's ultimate risk exposure of 5 percent of its capital and surplus for any investment in ETC's, and 10 percent of its capital and surplus for loans and investments in ETC's. What such an amendment would do is make it more difficult for a banking organization to protect its investments and loans to an ETC.

Some banking organizations may only want to organize an ETC for limited purposes. Permitting controlling investments allows them to do so without having to invest in ventures organized by others that may engage in a range of activities that may exceed their aims and entail more risks. Permitting controlling investments thus encourages the formation of smaller, independent trading companies, with less Zaibatsu-like combinations between banking and industry.

A banking organization may find that conflict-of-interest problems are minimized when it has control. A banking organization with many export customers may not want to join with any one or two customers in an ETC, but may want to set up its own independent ETC.

An ETC controlled by a banking organization would have no unfair competitive advantage over other ETC's or ETC's with minority bank participation. S. 2718 restrictions on total loans and investments and preferential lending are across the board and pertain whether a banking organization has either a minority or majority participation. Small ETC's also have the advantage of special startup assistance from SBA and EDA and a special Eximbank window, a privilege that would not appear available to most bank-controlled ETC's under the legislative criteria.

In addition to these reasons for permitting controlling investments, it must be noted that S. 2718 contains extensive safeguards in the case of controlling investments to protect against unwise risk exposure—these again are summarized in the statement.

The effect of these safeguards is to make it clear to all concerned that a bank cannot attempt an unwise rescue operation of an ETC, that it must deal with its affiliate on an arm's-length basis, and that the ETC must ultimately stand or fall on its own.

We believe it is much wiser to impose additional limitations on bank-controlled ETC's than to prohibit such control relationships altogether. In our judgment, the latter course would, as this committee has previously recognized in lifting control restrictions on bank investments in SBIC's, greatly discourage both bank investment and the development of ETC's. Limiting banks to minority positions also encourages the results that most concern you, Mr.

Chairman—it requires them to combine with manufacturers and other commercial concerns in jointly owned trading companies and gives them less means for controlling their own risk exposure.

In support of our recommendation, we would, of course, be willing to work with your staff and that of the banking agencies to develop whatever additional safeguards, if any, they might deem appropriate for ETC's controlled by one or more banking organizations. In particular, Mr. Chairman, we share the concern of the Federal Reserve that they not be faced with extensive rulemaking tasks under this legislation. Thus, we believe it may be possible to develop more definite statutory protections or standards on controlling investments that would avoid the need for detailed rulemaking and regulatory procedures.

CONCLUSION

I hope my testimony this morning has proved useful to the committee and my colleagues and I would, of course, be pleased to answer any questions you might have. I would also like to take this opportunity to express our willingness to work with your staff on any aspects of this legislation where our further input may be of assistance.

Thank you, Mr. Chairman.

[Statement follows:]

STATEMENT OF

BEN BAILEY

DIRECTOR

BANKERS' ASSOCIATION FOR FOREIGN TRADE

AND

SENIOR VICE PRESIDENT

AMERITRUST COMPANY OF CLEVELAND

Mr. Chairman and Members of the Committee:

My name is Ben Bailey and I am a Director of the Bankers' Association for Foreign Trade. I am also Senior Vice President of the AmeriTrust Company of Cleveland, Ohio's largest bank. I am accompanied today by the Association's counsel, Gary M. Welsh of the Washington law firm of Prather Seeger Doolittle & Farmer.

The Bankers' Association for Foreign Trade ("BAFT") was founded in 1921 by a group of banks whose purpose was to expand their knowledge of international trade and to develop sound banking services and procedures in support of trade. Today, BAFT's voting membership of 148 U.S. banks includes virtually all of those having significant international operations. The Association also includes as non-voting members 97 foreign banks maintaining offices in the United States, and thus embraces many of the major international banks of the world.

BAFT is pleased to have this opportunity to express its strong support for passage this year of S. 2718, "The Export Trading Company Act of 1980." As you know Mr. Chairman, BAFT previously testified in support of S. 2379, an earlier version of S. 2718, before the Subcommittee on International Finance. In that testimony, we discussed the need for export trading companies to stimulate exports by small and medium-sized U.S. business concerns and the contributions that banking organizations could make to their organization and development. In response to a number of concerns raised by the bank regulatory agencies, the Committee adopted a number of amendments now incorporated in S. 2718, which amendments we support. Nevertheless, we perceive from your statement announcing these hearings Mr. Chairman that a number of concerns and, we believe misconceptions, remain about the purpose and scope of bank participation in export trading companies (ETCs). In this light, I believe it would be most helpful to you and other Members of the Committee if I discussed the ways banking organizations might choose to participate in ETCs, and then addressed the major concerns that have been raised concerning bank equity participation. In particular, I would like to indicate why BAFT believes it is both necessary and appropriate to permit banking organizations to make controlling equity investments in ETCs.

WAYS OF BANK PARTICIPATION IN ETCs

S. 2718 does not dictate any particular form of banking organization involvement in ETCs, and we believe this is the best legislative approach to take. We agree with you Mr. Chairman that it would be inappropriate to adopt a Japanese Zaibatsu model for the U.S. economy and we believe that S. 2718 does not, in fact, adopt this or any other model. In this regard, I would like to discuss briefly some of the ways banking organizations may choose to participate in an ETC, and the protections included in the bill against a so-called Zaibatsu system ever developing.

First, I do not believe that S. 2718 is strictly a big or money-center bank bill. Within our membership, we have found keen interest in this bill among many regional banks. This is not surprising, since these banks serve areas that principally contain the literally thousands of small and medium-sized businesses that could be producing for export, but are not. Regional bankers time and again have seen these businesses decline to get involved in exporting when presented with the number of steps that have to be taken to arrange, negotiate, finance and deliver an export sale. These are the firms that want and need an export trading company.

Second, I do not believe that this legislation encourages combinations of large banks with large manufacturers. The large manufacturer does not need an export trading company to introduce its products to the world market. It is already there. It has the international network and resources to export its own goods or services and finds it more efficient and less costly to do so directly instead of through an intermediary.

What we do see from our discussions in the banking community is a number of possibilities for bank participation which can be as varied as our banking system and economy.

-- Some regional banking organizations may join together to form an ETC. For example, S. 2718 permits bankers' banks -- banks owned by a number of small banks -- to form an ETC. An ETC owned by a number of banks from the same region could provide a significant export stimulus to the area.

-- An ETC owned by a number of banks from different regions could stimulate the export of goods and services from throughout the country. For example, a banking organization with strong Far East relationships could join with another banking organization with strong South American relationships, thus expanding the worldwide export capabilities of a jointly-owned ETC.

-- Some regional banking organizations will prefer to organize and form their own trading companies. The regional bank may form such an ETC to give its smaller customers the one-stop service they need to enter the export market. A regional bank may form such an ETC to assist in facilitating trade with China, Eastern Europe or other areas where barter or so-called counter-trade elements may be required due to the lack of U.S. dollar exchange.

-- Some regional banking organizations may join with nonbank firms to establish an ETC, either on a permanent or one-shot basis. For example, a banking organization, an architectural firm, a construction company and a steel fabricator could form a "one-project" ETC to bid on a foreign tender. Or a bank might join with an export management company or freight-forwarder to organize an ETC that would provide an opportunity for the more efficient combination of their essentially complementary services.

-- Some banking organizations may use the opportunity to integrate and expand the types of trade services they already provide their customers. For example, an export finance subsidiary of a banking organization could better meet foreign competition on behalf of U.S. exporters if it could take title to goods in the course of a transaction instead of having to proceed through other intermediaries, an activity denied U.S. export finance subsidiaries in the past.

I would note Mr. Chairman that this list is intended as suggestive only. Nevertheless, I think it is useful because it indicates the wisdom of not foreclosing what may turn out to be valuable options by arbitrary statutory restrictions based on certain levels of "control."

THE ZAIBATSU CONCERN

We believe it clear from our discussion within BAFT and the banking industry that banking organizations interested in this legislation view it solely as a means for expanding the types of international trade services they can provide to U.S. business in order to promote U.S. exports, and not as a means for investing in or combining with U.S. business in contravention of our basic policies separating domestic banking and commerce.

First, S. 2718 only permits banking organizations to invest in ETCs, and limits any such investments to five percent of the banking organization's capital and surplus. An ETC must be principally engaged in exporting and facilitating the exportation of goods and services produced in the United States by unaffiliated persons. We believe it clear from the legislative history that "principally" rather than "exclusively" engaged in exporting was chosen as a standard in order to permit ETCs to engage in import and third-country trade transactions that might be necessary to carry on their business e.g., the import sale of goods acquired pursuant to a barter transaction. Nevertheless, we recognize your concern and the concern of other industry groups that the literal definition in section 103(a)(5) could theoretically permit a bank-owned ETC to engage in non-export/import domestic businesses -- e.g., the securities business. While we believe the bank regulatory agencies would use their authority under S. 2718 to prohibit such an extension of ETC activities beyond those intended by Congress, we believe language can be included in S. 2718 making this clear for bank-controlled ETCs.

Second, the strict limits on the amount of funds that a banking organization can lend to and invest in a trading company affiliate -- a combined limit of 10% of its consolidated capital and surplus -- ensure that a bank-controlled ETC would not have the resources to become a Zaibatsu-like conglomerate even if it had the ability to do so -- which, as pointed out above, it does not.

Third, the requirements for antitrust clearance under the Webb-Pomerene provisions and the banking agencies' authority to disapprove any investment over $10 M having adverse competitive considerations ensure against any combinations of bank and/or nonbank ownership of an ETC that would have deleterious competitive effects in the U.S. or on U.S. trade. The focus of the legislation is on giving U.S. firms the means to compete in export markets abroad. There are ample protections against untoward domestic competitive effects, including prohibitions on preferential credit extensions to ETCs or their customers -- the central thrust of our policy separating banking and commerce.

I hope Mr. Chairman, that my discussion has helped to dispel your concerns about S. 2718's possibly suggesting a Zaibatsu model for the U.S. economy. Essentially, S. 2718 permits banking organizations to invest up to 5 per cent of their capital and surplus in up to 100% of the stock of ETCs, in the same way Congress has permitted banking organizations to invest in Small Business Investment Companies (SBICs), among others. In this regard, we have found competitive concerns raised in the ETC context similar to concerns raised in the SBIC context and I would like at this point to quote from a report issued by this Committee in 1976 recommending legislation, which was approved, permitting banks to acquire up to 100% of the stock of an SBIC:

> "Section 108 of the bill would permit banks to own 100% of the voting common stock of a Small Business Investment Company. In 1967, the Small Business Investment Act was amended to prohibit a bank from acquiring 50% or more of the voting equity securities of an SBIC. The provision, which was initiated in the House, was provoked by concern over the 'monopolistic potential' of commercial banks in the SBIC program, although there was no evidence of abuse.
>
> "The SBIC industry and SBA have been actively working to bring more private capital into the program. Although many banks have expressed

> interest in the program, it is frequently difficult to find compatible coinvestors with sufficient assets. A bank's exposure is limited by law to a maximum investment of 5% of capital and surplus. Allowing banks to control or wholly own a license would serve to encourage financial institutions which are interested in the sound development of the SBIC program and would increase the amount of capital available for small business investment."1/

As in the SBIC case, we see no opportunity for a Zaibatsu-like monopolistic potential in our export trade, and believe that legislating on the basis of such unproven concerns, especially in light of the substantial protections already included in S. 2718, would have the principal effect of discouraging bank participation and thus the expansion of small and medium-sized business export.

SAFETY AND SOUNDNESS CONCERNS

S. 2718, as amended by the Committee on May 12, 1980, contains comprehensive safeguards that carefully limit and control possible banking organization exposure in export trading company investments. These limitations are at least equal to and often exceed those that currently apply to other permissible bank, bank holding company, or Edge Act Corporation investments.

1/ S. REP. No. 94-420, 94th Cong., 2d Sess. 8-9 (1976).

First, no banking organization, except an Edge Act Corporation not engaged in banking, may invest more than five percent of its capital and surplus in the stock of one or more ETCs. This is the same limit that currently applies to national bank investments in Small Business Investment Companies, and in community development corporations. In contrast, national banks can now invest in excess of five percent of their capital and surplus in safe deposit corporations, premises companies, bank service corporations, Edge Act and Agreement Corporations and agricultural credit corporations. There is no limit on the amount a national bank can invest in FNMA, GNMA, Corporations authorized under Title IX of the Housing and Urban Development Act of 1968, and the Student Loan Marketing Association. There is also, of course, no limit on the amount a bank holding company can invest in nonbanking companies permissible under the Bank Holding Company Act. The five percent limit is thus well within other recognized prudential limits. The twenty-five percent of capital and surplus limit for a nonbanking Edge Corporation is similar to that currently provided for nonbanking Edge investments overseas under the Federal Reserve's Regulation K.

Second, no banking organization can in the aggregate and on a consolidated basis invest and lend more than ten percent of its capital and surplus in or to an ETC. This ensures that the financial limitations of section 23A of the Federal Reserve Act apply to all banking organization/ETC investments, irrespective of whether the ETC is a majority-controlled affiliate. In contrast, bank-sponsored REITs have always been considered outside the limitations of § 23A. This provision thus puts a total prudential cap on exposure to a controlled or non-controlled ETC.

Third, the name of an ETC cannot be similar in any respect to that of a banking organization investor. This prohibition ensures against public confusion between a banking organization and an ETC affiliate and thus avoids the types of problems that arose in the REIT area.

Fourth, a banking organization must terminate its ownership of an ETC if the ETC takes speculative positions in commodities. This protects against an ETC affiliate's engaging in non-productive, purely speculative activities that could put a banking organization's investment at risk. In this regard, this provision will effectively require any banking organization investor to ensure that there are adequate internal controls in an ETC against speculation.

Fifth, S. 2718 specifically prohibits a bank from making preferential loans to an ETC in which it has an equity interest, including to any customer of such ETC. The language of the prohibition parallels that in the Financial

66-942 0 - 80 - 9

Institutions Regulatory and Interest Rate Control Act of 1978 on insider loans, and is thus a type of prohibition regularly enforced by bank examiners and the bank regulatory agencies.

Sixth, the banking agencies are given clear authority to require divestiture of any ETC investment that may constitute a serious risk to a banking organization investor. Again, this parallels powers which the Federal Reserve was given under the Financial Institutions Regulatory and Interest Rate Control Act of 1978 over other bank holding company investments.

While there are additional regulatory safeguards provided over controlling investments which I will discuss next in focussing on the control issue, BAFT believes the above limitations, restrictions and controls are appropriate and, in the aggregate, ensure against any exposure beyond traditional prudential limits for either non-controlling or controlling investments.

REASONS FOR PERMITTING CONTROLLING INVESTMENTS BY BANKING ORGANIZATIONS

Permitting banking organizations to make controlling investments subject to the limitations included in S. 2718 should not increase risks or potential competitive or conflict of interest problems, but, as indicated in the

Committee's Report (at pp. 10-11), should actually serve to reduce them:

-- A banking organization with a controlling investment is in a better position to protect its investment and regulate risk exposure. In this regard, many U.S. banking organizations have a policy in their international operations of favoring controlling investments, because equity control ensures operational control and hence better risk management. In this regard, if S. 2718 were amended to prohibit controlling investments by banking organizations, it would not in any way change a banking organization's ultimate risk exposure of five percent of its capital and surplus for any investments in ETCs, and ten percent of its capital and surplus for loans and investments in ETCs. What such an amendment would do is make it more difficult for a banking organization to protect its investments and loans to an ETC.

Some banking organizations may only want to organize an ETC for limited purposes *e.g.*, to assist in certain project financing, to export from a local region or to a specific trade area, or to merely expand their range of export trade services. Permitting controlling investments allows them to do so without having to invest in ventures organized by others that may engage in a range of activities that may exceed their aims and entail more risks. Permitting controlling investments thus encourages the formation of smaller, independent trading companies, with less Zaibatsu-like combinations between banking and industry.

-- A banking organization may find that conflict of interest problems are minimized when it has control. A banking organization with many export customers may not want to join with any one or two customers in an ETC, but may want to set up its own independent ETC.

-- An ETC controlled by a banking organization would have no unfair competitive advantage over other ETCs or ETCs with minority bank participation. S. 2718's restrictions on total loans and investments and preferential lending are across the board and pertain whether a banking organization has either a minority or majority participation. Small ETCs also have the advantage of special start-up assistance from SBA and EDA and a special Eximbank window, a privilege that would not appear available to most bank-controlled ETCs under the legislative criteria.

In addition to these reasons for permitting controlling investments, it must be noted that S. 2718 contains extensive safeguards in the case of controlling investments to protect against unwise risk exposure.

-- Any controlling investment, even if less than $10 million, must be approved by a bank regulatory agency. Control is defined according to Bank Holding Company Act standards, i.e., 25% or greater voting share interest, control of a majority of the directors, or exercise of a controlling influence.

-- No group of banks can acquire more than 50% of an ETC without prior agency approval, even if no one bank were to acquire a controlling interest, and no bank were to invest $10 million or more.

-- The agencies could disapprove any application for investment where, in their judgment, export benefits are outweighed by adverse banking factors.

-- The agencies can impose conditions and limitations on controlling investments to limit a banking organization's financial exposure or prevent possible conflicts of interest or unsound banking practices.

-- The agencies must set standards on the taking of title by banking organization-controlled ETCs to ensure against any unsafe or unsound practices that could adversely affect a controlling banking organization investor, including specifically with respect to the holding of title to inventory.

-- The agencies can examine banking organization-controlled ETCs and use cease-and-desist authority to enforce any and all requirements imposed under the law.

The effect of these safeguards is to make it clear to all concerned that a bank cannot attempt an unwise rescue operation of an ETC, that it must deal with its affiliate on an arms-length basis, and that the ETC must ultimately stand or fall on its own.

We believe it is much wiser to impose additional limitations on bank-controlled ETCs than to prohibit such control relationships altogether. In our judgment, the latter course would, as this Committee has previously recognized in lifting control restrictions on bank investments in SBICs (*see* pp. 9-10 *supra*), greatly discourage both bank investment and the development of ETCs. Limiting banks to minority positions also encourages the results that most concern you Mr. Chairman -- it *requires* them to combine with manufacturers and other commercial concerns in jointly-owned trading companies and gives them less means for controlling their own risk exposure.

In support of our recommendation, we would, of course, be willing to work with your staff and that of the banking agencies to develop whatever additional safeguards, if any, they might deem appropriate for ETCs controlled by one or more banking organizations. In particular, Mr. Chairman, we share the concern of the Federal Reserve that they not be faced with extensive rulemaking tasks under this legislation. Thus, we believe it may be possible to develop more definite statutory protections or standards on controlling investments that would avoid the need for detailed rulemaking and regulatory procedures.

CONCLUSION

I hope my testimony this morning has proved useful to the Committee and my colleagues and I would, of course, be pleased to answer any questions you might have. I would also like to take this opportunity to express our willingness to work with your staff on any aspects of this legislation where our further input may be of assistance.

The CHAIRMAN. Before I question you, I would like to take a few minutes to call attention to what I think we have not had a chance to discuss here, and it is unlikely we will, because you are here primarily representing the bank communities—you should be—but I am concerned about the effect this is likely to have on our free competitive system. After all we do extend Webb-Pomerene exemptions to antitrust and yank out of the Justice Department, at least part of the administration of antitrust. That is a power it had since passage of the Sherman and Clayton Acts. The importance of this is well stressed by a man a few years ago who said this and I will read a short paragraph—

> Over the years, the Federal Government, in Republican and Democratic Administrations, enacted the Sherman and the Clayton Acts to prevent concentrations of power in plutocratic hands, and no wiser or more beneficial legislation has ever been enacted in America for business. In Europe, where these laws are incomprehensible, and a cozy hand-in-glovism between governments and industries has its expression in the cartel system, we see many brilliant accomplishments. But we don't see any properly significant diffusion downward of the profits and benefits of the industrial system, which, in this country, constitutes our most effective safeguard against radical infection in any large masses of our public.

That statement was made by your father, Adlai Stevenson. [Laughter.]

Senator STEVENSON. I wish I could call him as a witness. [Laughter.]

The CHAIRMAN. So do I. Mr. McCormick, you make constructive suggestions for modifications in the legislation. Do you oppose this legislation unless those modifications are made? Its present form?

Mr. MCCORMICK. We would oppose it with deep regret because we think we need to develop export trading companies. It's extremely important that it be done. But we don't think banks as a bank should totally control them, and we are not convinced that the only knowledge possessed in export trading is possessed by the banking industry. We should feel highly complimented with the impression that it is only the banks that have the wisdom to accomplish this.

The CHAIRMAN. Mr. Stucky, in the past 6 years, we listened to the questioning and some of the statements made this morning you get the feeling this country has done very badly in its exports. In the past 6 years exports increased an average 17 percent each year and that very sharply exceeded the growth rate of GNP which increased 10-percent average. It was a much higher rate of increase than our inflation rate.

Imports during that period increased on the average of 20 percent each year, true, but that was because of the sharp increase in the price of oil. Not entirely but that was a big element. That suggests to me the problem is on the import side of the balance sheet, not the export side and it primarily revolves around the ever-increasing price of oil and oil consumption. What evidence is there that bank ownership and control of export companies rather than banking participations represented by the Federal Reserve to lessen equity ownership will serve the nation better?

LACK OF EXPERTISE

Mr. STUCKY. Senator, I would try and comment to that question in two ways. No. 1: It has historically been difficult for commercial banks to provide international services to smaller customers. The logical question is: Why? Generally there is a lack of expertise on the staff of that exporter. He comes to you to seek free an informal financial and international consultanting services. He takes the recommendations that you make to him. You expect him to carry out the recommendations in line with traditional practices relative to the documentary aspects, the import license, the other governmental regulations that have to be complied with in an export sale. More often than not banks involved in international trade have in fact found themselves in a difficult situation where they have assumed that the customer was performing such things and it turns out later on some aspect was overlooked. Suddenly you learn there was not foreign exchange authorization from the importer's country thus, you face a possible loss if not covered with export credit insurance. That kind of implied responsibility in relation to the small fees you can earn from such business and the potential adverse publicity one can get from the smaller businessman who says I talked to my bank. They said do this. I did it and lost money. That puts the bank in an awkward and embarrassing position in the community. We like to avoid that type of responsibility where documentary and other risks are not properly covered by a third party.

By dealing with an export trading company who specializes in providing those services, the overall quality of the documentation and the way in which the transaction is conducted will provide for more prudent control of the transaction risks. That is the important thing.

The CHAIRMAN. It is hard for us to find in the bill anything that would focus or concentrate the promotion on small business. I take it from your response that the principal benefit here would be that the big exporter can take care of himself and is anyway, and perhaps would not be part of an export trading company. But the small business that is now left out feels incompetent to deal with exports because it is a very big step. I cannot find anything in the bill that would explicitly focus on the small businessman. What is it?

Mr. STUCKY. I do not know if it is specifically in the bill but I would like to respond to it in this fashion. I agree with your statement on the major multinational corporations, I believe they have the skills and I believe they have carried out their responsibility properly. We do not address their needs they have that capability. In many instances, though, working with Department of Commerce officials and trade seminars we hear of the problems I related in my testimony, namely that small exporters do not know how to locate a market or handle the documentation.

My feeling is that through the export trading company vehicle, a bank has the opportunity through its calling efforts to introduce potential exporters to a trading company who can provide nearly the same level of expertise as is available at a multinational. A bank has an incentive and desire to want to refer those potential customers to a sophisticated, responsible firm, so that an export sale is looked upon as desirable and profitable.

Likewise by having share control itself in the export trading company, its policies, its management and practices, the bank believes it can both control the quality of the referral and quality of the service which the exporter gets, and thus meet the needs and ultimate goal of the exporter in this country and for improved export positions and commitments.

AMENDMENTS

The CHAIRMAN. Let me ask about two amendments. The first would confine this to small- and medium-sized businesses. What would you think of that? If we had an amendment that provided the trading companies would have a limit in the size of the business?

Mr. STUCKY. My offhand reaction is that it deserves merit but I would like to cite one example which I think would be handicapped if you adopted that particular amendment. Let us take the example of a company, such as International Harvestor or Caterpillar, both small major quality exporters. Small firms that make accessory or complementary products for International Harvester or Cat Tractor flows through the same distribution network, but the supplier does not have a dealer network to sell its products. I could see where those multinational corporations would set up separate ETC's to sell the complementary products which would benefit the individual suppliers who do not presently have those kinds of export capabilities. I would not want to preclude that form of ETC because of overly restrictive legislative language in S. 2718.

The CHAIRMAN. How about another amendment? How about confining this to financial services?

Mr. STUCKY. I would have to ask the simple question: What are financial services? I hate to make lists of things.

The CHAIRMAN. You just filed your position entirely on the basis of financial services. Not the ownership of construction companies, for example. Shipping lines. That kind of thing.

Mr. STUCKY. Some banks—it depends on each bank's own management philosophy and whether they feel they have the quality of staff that could administer, for example, a construction contract, or if they just wanted to limit financial services. Some regional banks or some money center banks might be more inclined to provide management and financial services for cement mills or other large technical projects throught the life of a turnkey contract than would certain other banks or firms.

I feel scribing out in the legislation just exactly how export trading companies could operate in the future would be a mistake. Flexibility is needed for the concept to evolve, in corporation with regulatory control, so in the future we can adapt to the changing trade and industrial patterns of the total global economy. We are pioneering into new territory and thus I do not think we should be too liberal. However, I do not think we should be too restrictive either because it often becomes almost impossible to obtain change down the road.

The CHAIRMAN. Confine it to the areas, at least at first, of financial services, perhaps small business, and see how that operates. Then move ahead if it appears to be necessary. Once you go the whole way, there is no way you will cut back if it is a mistake.

Mr. STUCKY. I think what we are trying to highlight is that certainly myself as a banker and probably the members of this committee cannot today perceive all the safe ways that an ETC could or should operate.

The CHAIRMAN. You then would favor this if it were principally engaged but not solely engaged. Is that right?

Mr. STUCKY. Yes, sir, but from the standpoint of my basic position, the philosophy of how ETC's can be used and should be permitted to grow and develop in the international marketplace should not be fixed at this time.

The CHAIRMAN. You are saying you would support an amendment to the bill along these lines. I take it you did not object to the first part of it, to invest in up to 20 percent. That was up to 20 percent. Not more. Up to 20 percent of a noncontrolling interest in export trading——

Mr. STUCKY. Our position is we support the bill as it was reported out of the committee. We make the premise, however, or take the position that if for some reason the Senate or Congress feels that bank control of an ETC is not proper at this time then the overall importance of exporting is so compelling that an accommodation must be reached, we will listen and work with you in developing it. The ABA feels that controlling ownership by a bank of an ETC is preferable and prudent.

The CHAIRMAN. You took a diversion as you read your statement than you did when you actually delivered it. You said when you read your statement just what you said now—when you read your statement this morning, but your prepared statement says the following:

Should this Committee or the Senate, in its wisdom, seek to restrict bank participation in export trading companies, the American Bankers Association would support such efforts in order that this vital legislation may move expeditiously through both Houses of Congress.

You said when you delivered your statement you would not oppose it. Now you say you will not oppose it. But your written statement, which I take it was approved by ABA, is that you would support it.

Mr. STUCKY. This final page was typed up somewhat late yesterday afternoon and the statement per se has been modified and we would like to submit that revised page which is correct in my summary.

The CHAIRMAN. When you say you would not oppose but—you would not take the initiative to support that change in the legislation; is that right?

Mr. STUCKY. Yes.

The CHAIRMAN. There is quite a difference. ABA is a very important organization. We want to know where you stand. That is it.

All right, my time is up. Will you permit Mr. Bailey to respond?

Senator STEVENSON. Yes.

IMPORTANT FOR BANKS TO HAVE CONTROL

Mr. BAILEY. We would feel it extremely important from just good business sense to permit the bank to control for the safety and security of the bank itself and its involvement in the ETC. I think it is also extremely important that banks be permitted control because I think in the near term it will be the banks who will move first into trading companies. I think it will be sometime before others go into it. Once they have seen the experience and success of the banks, they will. I believe the banks have the confidence to move into it.

From my own experience, I take a little offense at the fact there are not people in banking today that could operate a trading company. I think there are people who moved from industry into banking today and have the expertise to run trading companies and run them properly at no greater risk to the banks—5 percent of capital and surplus, legal lending limiting to 10 percent. We had a trading company operating within the United States that went under. I don't remember any bank being going under as a result of it.

Many banks were up to the legal lending limit with them. We survived that. Keeping us to 5 percent on trading companies, we can make it. You also threw in something about limiting us to small- and medium-sized companies. Basically that is good but I think the real quantum leaps in export as a result of the establishment of trading companies will come in the ability to go out and quote on and obtain the business on huge projects around the world.

If you travel and see the commercial attachés in each country as we do they will tell you today that American companies just are not out there any more because 15 American companies have to come in, small, medium and large, to bid on a contract. The Japanese come in with one bid covering the whole project. The guy on the other end will be much more willing to look at that one bid from a packaged trading company than they are 15 different people coming in promising different delivery times, et cetera.

To keep the big companies out who may be important in project financing, we are punishing ourselves in the opportunity the trading companies will provide. We need the quantum leap in exports. Project financing is where we will get it.

The CHAIRMAN. My time is up.

Mr. PETERSON. Can I ask on a point of clarification? We are talking about a 20-percent noncontrolling investment. That does not, say, preclude five banks getting together and having total ownership of the company, does it?

The CHAIRMAN. Not beyond 50 percent. That was the Fed amendment. It couldn't go beyond 50. Does that change the position?

Mr. PETERSON. No.

Mr. MCCORMICK. No; it does not.

The CHAIRMAN. Senator Stevenson.

Senator STEVENSON. Thank you, Mr. Chairman.

Mr. Stucky, let me see if I can restate the position of the ABA so there is not any misunderstanding in the record.

As your statement indicates, the American Bankers Association strongly supports S. 2718, as reported by the committee, but you would support restrictions on bank participation—additional participations on bank participation in trading companies only if it becomes necessary to secure legislation; is that your position?

Mr. STUCKY. Yes.

Senator STEVENSON. I hope that does not become necessary. I will come back to that.

First, another point needs to be clarified. The chairman's question, if I understood it correctly, was whether you would support an amendment which restricted bank participation to less than 20 percent in the equity of a trading company and only with regulatory agency approval to companies engaged solely in export trade.

That phrase got by you, I think. Is there any one of you that thinks it is possible to have a trading company engaged solely in exports?

Mr. STUCKY. Our full statement talks in terms of both exporting and importing and other activities. So it is not to be solely exporting.

Mr. MCCORMICK. The way I would like to respond to that is to say we would support an amendment which would apply a standard to the principal material used in a range of, say, 80 percent of the gross revenues or something along those lines, being primarily involved in export trade.

We have a great deal of concern, very frankly, in terms of talking about importing. After all, the committee report expressed one of the reasons why the Webb-Pomerene associations have not been successful in the last 60 years is because they lack sufficient product market domination to exert foreign market price control and membership discipline.

Now, we may be willing to try to meet our foreign neighbors with counter domination mechanisms, but I don't think we will be willing to do that to ourselves with importing functions in the United States.

Senator STEVENSON. Are not you reading from the Chairman's dissent and not from the committee's report?

Mr. McCORMICK. I will have to——

The CHAIRMAN. That's the best part of the report. [Laughter.]

Mr. McCORMICK. I was sure it was a general part of the report; page 14, sir.

BARTER TRANSACTIONS

Senator STEVENSON. Anyway, trade is a two-way street. It's becoming increasingly complex because of the unreliability of currencies. It involves barter transactions. A lack of institutions which transact by barter. Foreign trade. Increasingly, the instability of currencies, the uncertainty about their value; trade frequently involves third and fourth countries. Products may be sold in one country in exchange for products which are sold in a third country and so on. We do not have the institutions with which to conduct such transactions.

That brings me to one of the continuing misconceptions about this bill. It would provide small- and intermediate-sized firms a chance, a possibility of exporting, but its purposes are not confined to the small companies. It also provides the largest companies with opportunities, as I think you, Mr. Bailey, emphasized, to package the large transactions. These trading companies will represent competing products, competing companies, and put together billion dollar turnkey transactions.

They will represent the largest as well as the smallest corporations, and not only by putting together large transactions, but sometimes very complex transactions involving barter in third and fourth countries.

The largest countries will be beneficiaries of those services as well as the smallest countries. If there is any doubt about the importance, look at the experience of foreign trading companies.

I personally would be opposed to anything that gutted this bill by attempting to confine it to some arbitrarily defined sizes of the companies. They will also end up suffering as a result of the lost opportunities that the small companies have to supply the large companies which benefit as a result of the services from trading companies.

Now, I have no problems with the suggestions that have been made about the word "principally"; or the definition of bankers' banks. I already mentioned we ought to work out language that eliminated any of the present concerns about the involvement of trading companies in nontrading, nonbanking activities. Those problems alluded to can be taken care of. If so, we are pretty much reduced to this issue of control.

So, let me ask you, Mr. Stucky, how important it is. Would banks invest in trading companies without control? How much difference to the attitudes and probable investments would it make if they were deprived of an opportunity to acquire controlling interests in trading companies?

Mr. STUCKY. Senator Stevenson, I think, to repeat a couple of things that have been said, in our statement we make a case that controlling investment in an ETC we feel is the best position for commercial banks because they are indeed complying with responsibilities, vis-a-vis the things which happened with the REIT's.

We have tried to recognize that regulators and Members of Congress may see this as invading a new territory where they would not like to have such potential broad ownership by banks in export trading companies that could control other businesses. We are prepared to listen and to finding a way to make this bill acceptable, both to our own constituency and to the Congress in the hope of creating a positive thrust to the overall export efforts of this country. If that means reducing the ownership from less than 100 percent to some other level, then we are prepared to consider lesser ownership initially if we are satisfied that the legislation assures a regulatory review process—based on impirical experience of ETC's to ultimately allow banks to have controlling interest of an ETC.

Senator STEVENSON. That is not my question. What if we did put in a new restriction and effectively prevented banks from acquiring controlling interests. What would be the effect of such a restriction on the attitude of banks toward participating in trading companies?

Mr. STUCKY. I will speak in the case of—I think I understand your question better with the help of Mr. Valentine. If I do not, be patient, I will get to it.

In the case of my own bank we have looked into this with some interest; have decided that it would not be essential for us to have any more than 20-percent control. We know there are other regional banks similar in size to ourselves which have somewhat different philosophies. First Wisconsin thinks that a successful ETC should combine the talents of an experienced marketer to be able to handle the marketing side of the export trading company activities, and also and EMC to handle the distribution and service aspects of an ETC.

From that standpoint, my own bank could be satisfied with that. I think within the industry, that would not necessarily be the general position. Each bank has its own management philosophy for good reasons and often with similar results. The ABA export task force on ETC's and the discussions held at a recent Government relations council meeting indicated that most U.S. banks studying the ETC concept generally held expectations that they would be allowed, under S. 2718, to have controlling interest in an export trading company. It is our impression that many banks would not be strong supporters of, or investors in, FTC's unless they would be allowed to have effective control, with appropriate regulatory safeguards or controls, in an ETC which they were associated with.

I will ask Mr. Valentine to comment in the case of his own bank, or generally.

Mr. VALENTINE. Without giving the views of my own bank, which I am not prepared to do at this time, there is one consideration I think about a bank's having control of an ETC which would be sufficient reason for excluding the 20-percent level we have been discussing. It is simply this: One could perceive of certain situations in which a bank would be committing more than just funds when investing in an ETC enterprise. For one reason or another, publicity, what have you, strong public identification would be likely to emerge as a result of this investment. Therefore, fundamental to investing in an ETC, a bank would be committing the most important thing it has. That is to say, it would be investing its reputation, its respect, and overall public relationship in the community as well as its funds. Therefore, I can conceive of many situations where a bank could be most reluctant to embroil itself into this kind of activity unless it can be assured that it could protect its fundamental base values which it had accummulated over the years. These values would have to be kept absolutely impeccable.

The upshot of this is that our view is if you wish banks to participate in the ETC type of business—by promoting foreign trade—then it could be best to leave the question of how much percentage a bank could be permitted to put into the ownership of an ETC unanswered and openended.

On the other hand, it is the ABA position, which we fully support, that if in the wisdom of the Congress this committee, it is felt that there must be a 20-percent limitation, to obtain passage of this legislation, then, of course, we think the ETC concept is so important that the committee should not jeopardize the bill for any reason.

I hope that answers your question.

Senator STEVENSON. I understand the position, but—are there any other responses to the main part of the question, which is what would the effect of that 20-percent limitation be on the participation of banks in trading companies?

Mr. McCORMICK. I might say briefly for our constituency, which are the smaller banks in the country, by and large, that if the bill was passed, we would have our banks going together in groups to get involved and there would not be any problem at all. I would be surprised to find a bank of less than $100 million wanting to control or own an export trading company of its own.

Senator STEVENSON. What if they were excluded or prevented from acquiring more than 50 percent?

POTENTIAL CONFLICT OF INTEREST

Mr. McCORMICK. That would be an acceptable limitation. I would want to say we have real concerns about this bill. They are in the area of potential conflict of interest.

From the point of view of if these companies became subsidiaries of the banks, the banks' liability and relation to those operations will pretty well be the total limits of the operations rather than just what they have invested. The concept that the trading company would have to have a name other than a bank in order to not trick people I think is simplistic. People know who owns the place. If it is a bank, they rely on it. So we have real concerns in that area.

We have some conflict-of-interest concerns. You have to remember these people are not only exporting but they are importing.

They have an opportunity to suggest to people not only where they sell, but where they buy.

Senator STEVENSON. Could we just hear from Mr. Bailey?

The CHAIRMAN. Certainly.

Mr. BAILEY. If I may, I would like to refer the committee to testimony by Mr. Paul Cooper, president and chief executive officer of Acme Cleveland Corp., a major machine tool builder in the United States, before the House Subcommittee on International Trade, July 1. He was also speaking on behalf of the National Machine Tool Builders Association.

I think we recognize this is one of the industries where we have a great opportunity for increasing our exports, and there are problems. Trading companies can really help them. He states quite a case here. Part of his presentation for allowing control by banks of trading corporations.

He gets into this. We had no influence on this. We did not know—I do not think anybody in our area knew he had been down testifying.

In our view, any legislation purporting to encourage United States export through the facilities of export trading companies which does not permit bank participation, and in some cases the right of bank control, is only a half step.

Senator STEVENSON. Thank you, Mr. Chairman.

The CHAIRMAN. Well, I take it, Mr. Stucky and Mr. McCormick both feel—Mr. Stucky, you feel you would prefer the bill as is, but you would not oppose the limitations which the Fed proposed; is that right?

Mr. STUCKY. That is correct.

The CHAIRMAN. Mr. McCormick, you support the Fed position?

Mr. MCCORMICK. Yes; we do.

The CHAIRMAN. I have one point. That is to commend you, Mr. McCormick. Your eye is sharper than mine. I could not say when you said this, when you made your reference to the Webb-Pomerene associations formed over 60 years lack sufficient product market domination to exert foreign market price control and membership discipline. That is from the committee report, page 14. My dissent does not start until page 31. That was the body of the report. That is what the majority said. Price fixing; that is what they want.

Thank you very much, gentlemen. We appreciate your testimony.

The CHAIRMAN. Next we have E. S. Finley, Prof. Robert C. Clark, and Mr. Inman P. Ellis. We are especially honored to have a former member of the committee, Senator Clifford Case from New Jersey grace this committee. Senator Case is in great physical shape.

Mr. Finley, you know the hour is late. We would appreciate it if you could abbreviate your remarks.

STATEMENT OF E. S. FINLEY, PRESIDENT, INTERNATIONAL COMMODITIES EXPORT CORP.

Mr. FINLEY. Thank you, sir.

Mr. Chairman, my name is Emil Sherer Finley. I am president and chief executive officer of the International Commodities Export Co., a firm which I founded over 30 years ago and which has become a prominent exporter of agricultural chemicals, with an annual volume close to a quarter of a billion dollars.

May I first express my appreciation for the opportunity to appear today before you and your committee to present my views and those of my company in connection with S. 2718.

Nobody can question the importance of increased exports to our economy. While those of the other industrialized countries frequently represent 20 to 40 percent of their gross national product, ours represent barely 10 percent. With a continuing annual trade deficit running into many billions of dollars, it is understandable that all of us are deeply concerned. Unfortunately, some well-meaning legislators and certain private interests are creating a climate of panic to gain quick acceptance of solutions which eventually will hurt our country much more than the current deficits. Indeed, I am sad to note that Congress can only come up with a bill to encourage the creation of U.S. trading companies and expanded antitrust exemption of U.S. export activities by amendment of the Webb-Promerene Act.

These voices are simply saying that if we will allow virtually unbridled price fixing, with immunity under antitrust laws, our failure to export a substantial share of our gross national product will have been corrected. I am chagrined by this bill as a businessman, as an exporter, as an entrepreneur and as an economist.

For the past two decades, we have been told over and over again that billions of dollars worth of potential annual export business is neglected because small- and medium-size producers are unable to develop foreign markets. We have also been told that only 1 in 10 U.S. manufacturing firms sells abroad. We are told that this new legislation would help materially to get these small producers to export. The fallacy of it is that the world has changed in the last quarter of a century and even the developing and underdeveloped countries now have local industries which can produce the needed goods we are talking about and, therefore, in most cases, make it almost impossible for the United States to succeed in such exports. We are also told that important service contracts abroad elude our major contractors, but there is nothing in our antitrust laws that prevents our major contractors to join together in projects.

This highly publicized bill, S. 2718, tells us that we should go the OPEC way. My personal experience tells me otherwise. One measure of the success of my company is the fact that, since 1948, U.S. exports have gone up 1,400 percent, while our own exports have gone up 9,200. We did not need any protective devices or legislation to do this. We were able to do it because we paid close attention to the forces of supply and demand and because we were willing to be competitive. Surely, we have shown that we are in favor of expanding U.S. exports by making this contribution over the years. We are in favor of further expansion, but we believe that such expansion should be on the basis of increased, and not restricted, competition.

COMMITTEE WARNED OF DANGEROUS FEATURES

The purpose of my coming here is to warn this committee of the dangerous features of any expansion of the antitrust exemptions under the Webb-Pomerene Act. I have testified in 1978 before the National Commission for the Review of Antitrust Laws and Procedures. I have also presented a lengthy policy statement before the National Journal's policy forum in 1979.

I have testified before the Subcommittee on Foreign Commerce of the Committee on Commerce on S. 2754 in January 1972. I request that all of these statements and enclosures be included in the hearing record.

The CHAIRMAN. Without objection.

[Information follows:]

[Reprinted from hearings of January 1972 before the Subcommittee on Foreign Commerce of the Senate Commerce Committee titled "The Export Expansion Act of 1971"]

Mr. WARREN C. MAGNUSON,
Chairman, U.S. Commerce Committee,
Washington, D.C.

DEAR MR. MAGNUSON: Pursuant to the request of Business International (D&B) relating to the proposed bill S. 2754 concerning export expansion activities and related purposes. I request the following statement and enclosures be included in the Hearing Record:

I have read carefully the proposed bill S2754 and I am shocked and horrified by the proposed Titles VI and VII respectively relating to joint and chartered export associations. I am sure that there are few of us who do not recognize the importance of the expansion of our export trade. As president and chief executive of a well-known and successful export company with a tradition in international trade going back to the 19th century, I would hope to be well qualified to analyze and evaluate the disastrous effect that these two titles would have, not only on export trade of the U.S. as a whole but on life in the U.S. as we know it. Titles VI and VII are a carte blanche to unbridled price fixing, quotaing and restrictive practices of the first order which would transcend any of the past and present conspiracies, be they here or abroad, and therefore, would without any doubt materially affect competition and our lives in these United States to a point where each and every one of our citizens would suffer. Titles VI and VII of this bill would generate a new gigantic tidal wave of inflationary pressures which, added to the current inflationary waves and their propensities, could consume our economy.

With the possible exception of Titles III through V and above-mentioned Titles VI and VII, the other titles of the proposed bill could be of great help to the export trade and to our economy. I am particularly alluding to the ocean freight rate disparities which our company has been fighting for a great many years, including our own complaint several years ago to the Federal Maritime Commission.

The proposed relief from antitrust prosecution would lead us in the opposite direction from the one in which the United States should be going.

I have lead this company over the past two decades from relative obscurity to international prominence in the line of fertilizers and allied products. Throughout that time, this company has been compelled to compete strenuously against foreign cartels. We were able to do this effectively because we have been expressing judiciously the forces of supply and demand as it became necessary, and we have not been paying homage to any artificiality of the marketplace nor rigging the market. Our record is that of continued success. One measure of this could be provided by comparing U.S. exports as a whole in 1947 with those in 1971 on the one hand and our own exports in 1947 and 1971, on the other, U.S. exports in the past quarter of a century have gone up 300 percent while our own exports have gone up 4000 percent!

Throughout and prior to that time, various export associations have come and gone. Basically, their success was miniscule if at all, and their presence generally restricted rather than expanded U.S. foreign trade.

I should like to draw your careful attention to the hearings before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, U.S. Senate, 90th Congress, First Session, pursuant to S. Res. 26, which took place on June 23 and June 26 through June 30, 1967 (U.S. Government Printing Office 87-083). During those hearings, the international aspects of antitrust were discussed in minutest detail comprising a complete review of the Webb-Pomerene Act of 1918, over half a century during which this act was put to test. It is a sorry picture covering 50 years of utter failure of export associations, proving over and over again that they did not offer any significant advantages to the U.S. over exporting product through export merchants. The study confirmed the fact that a specialized export firm has far more to offer at any time than has an association.

The proposed Title VI and VII of bill S2754 would set our clock back not by just 50 years, but I dare say more likely by 250 years.

It is in consideration of the all-important aspects of this proposed bill that I wish to stress the effects that Titles VI and VII could have on our economy, both with regard to preserving competition and arresting inflationary pressures to ensure that the U.S. again become an effective force in international commerce.

In support of my statement, I am enclosing photostats of the following documents which I request be also included in the Hearing Record:

1. Letter from E. S. Finley, President of International Commodities Export Corp. (ICEC) to Maurice H. Stans, Secretary of Commerce, dated July 6, 1971.
2. Letter from Sam J. Ervin, Jr., Senator from North Carolina, to E. S. Finley, dated July 12, 1971.
3. Letter from Hugh Scott, Senator from Pennsylvania, to E. S. Finley, dated July 13, 1971.
4. Letter from Edward J. Gurney, Senator from Florida, to E. S. Finley, dated July 14, 1971.
5. Letter from Jacob K. Javits, Senator from New York, to E. S. Finley, dated July 19, 1971.
6. Letter from John V. Tunney, Senator from California, to E. S. Finley, dated July 22, 1971.
7. Letter from Maurice H. Stans to E. S. Finley, dated August 3, 1971.
8. Letter from E. S. Finley to Maurice H. Stans, dated August 17, 1971.
9. Letter from Vincent D. Travaglini, Director, Foreign Business Practices Division, to E. S. Finley, dated August 26, 1971.
10. Letter from E. S. Finley to Vincent D. Travaglini dated September 17, 1971.
11. Letter from E. S. Finley to the President of the United States, dated September 17, 1971.
12. Letter from Vincent D. Travaglini to E. S. Finley, dated September 27, 1971.
13. Letter from the White House by Peter M. Flanigan. Assistant to the President to E. S. Finley, dated October 4, 1971.
14. Letter from Philip A. Hart, Senator from Michigan, Chairman of the Subcommittee on Antitrust and Monopoly, to E. S. Finley, dated October 14, 1971.

All the above correspondence focuses on the antitrust aspect of export associations, be it under the aegis of the Webb-Pomerene Act or, worse still, under Titles VI and VII of the proposed bill S2754.

Secretary Stans, in his letter to me of August 3, indicated that he is "inclined to the view that the Act has not been utilized to its full potential as an effective instrument for the promotion of exports" and that ". . . joint exporting is being successfully employed in all of the major exporting countries." The antitrust laws of most, if not virtually all our foreign competitors are totally emasculated and meaningless. It is for this reason that antitrust exceptions and techniques similar to the Webb Act and that described in Titles VI and VII of the proposed bill S2754 outside the U.S. appear effective. Here in the U.S., we would refer to these as illegal cartels, conspiracies frequently harming the respective nations in the long run.

Even with this lack of adequate antitrust laws abroad, most of these cartels when faced with the reality of supply and demand, have failed miserably. For example, when the supply of certain fertilizers by far exceeded the demand on a global basis, the well-known European fertilizer cartel "Nitrex" and the Japanese fertilizer cartel "Japanese Ammonium Sulphate Export Association" suffered bad defeats in the marketplace resulting in heavy losses for the respective industries. The United States' own performance of "legal" associations has contributed just a little more than half of one percent toward our overall exports in the last 50 years of experience. With virtual full protection from antitrust prosecution, this is truly a miserable performance. Surely our productivity is not going to be enhanced by restrictive practices, legalized conspiracies and quotas. These are not the techniques which at one time helped us to be the greatest economic power in the world.

It is my fervent hope that you will examine the record of these associations as revealed throughout the 364 pages of Document 87-083 covering the above-mentioned 1967 Hearings on International Aspects of Antitrust. It is also my plea to you that, predicated on these extensive studies, the idea of Titles VI and VII of the proposed bill S2754 be totally abandoned and that antitrust laws governing export associations be strengthened in the most forceful manner to assure that economnic decisions be made by the greatest number of people in the marketplace and not through contrived combines with dubious and erring decisions of the few which have proved so harmful to the totalitarian economies, be they of the left or the right.

Sincerely,

E. S. Finley, *President.*

Enclosure.

JULY 6, 1971.

MR. MAURICE H. STANS,
Secretary of Commerce,
U.S. Department of Commerce, Washington, D.C.

MY DEAR MR. SECRETARY: On June 26, you declared that the United States "has been losing and is continuing to lose its competitiveness in world markets". You also stated that our competitive advantage has been lost in terms of price, productivity and technology, and that our competitors have been trying harder than the United States has to make export sales. The remedies that you suggested comprise an increase of our investment, especially in research and development, in addition to appropriate investment credit and accelerated depreciation allowances, particularly for those industries which will provide the bulk of the future's exports.

The other suggestion which you made was that "we need to examine our antitrust philosophies" which "may no longer be appropriate for industries competing against foreign producers free of such restraints". We think that your appraisal of the U.S. position as an exporter is realistic. We also think that your suggestions, with the exception of the latter one, are helpful. However, we believe that your proposed examination of our antitrust philosophies should be running in the opposite direction from the one which you recommend.

I am the president and chief executive of a fertilizer exporting company. Our annual exports are about $45-million, representing close to 25% of the total United States' manufactured fertilizer exports. I started this company virtually from scratch after World War II and have let it through more than 20 years from obscurity to prominence. In addition to fertilizers, we handle certain chemicals and some equipment.

Throughout this period of time, we had to compete against various foreign cartels. We were effective because we were not encumbered by commitments to any groups. And we could give free expression to the forces of supply and demand as we saw fit and necessary. The advocates of more liberal antitrust laws insofar as foreign trade is concerned, appear to be oblivious to the fact that the international aspects of antitrust were carefully reviewed by the United States Senate in 1967 when reviewing the Webb-Pomerene Act of 1918 on June 23, 26, 27, 28, 29 and 30 of that year.

These hearings have proven beyond any doubt that half a century of experience with the Webb-Pomerence Act, which virtually freed the trade associations from any antitrust obligations or prosecution, have not proven to be an effective instrument either for the expansion of U.S. exports as a whole or for the expansion of exports by small firms. The hearings also concluded that the Webb-Pomerene association did not offer significant advantages over exporting through brokers and export merchants. It further stated that "in most industies, a specialized export firm has more to offer to the small exporter than has an association".

The further conclusion of the hearings was that "nothing in the changing environment of American involvement of economic and international activity justifies an expectation that the Webb-Pomerene Act will assume increased significance as an instrument to promote overall U.S. exports" . . . "the major beneficiaries have rarely been firms that needed to cooperate to cope more effectively with the bargaining power of foreign buying cartels."

Conversely, large companies who operate foreign manufacturing subsidiaries or collude with foreign producers and are generally members of oligopolies are most likely to yield undesirable anticompetitive effects.

Export competition of the United States should be encouraged if the U.S. is to participate to a great degree in international trade. Any easing of antitrust philosophies will have the reverse effect and would cause this nation to be less effective against foreign cartels.

The other problems, i.e., that of price and productivity, of course gets us into the area of labor costs. Some segments of our basic industries have been rebuked on various occasions for raising prices of their products. However, these increases were by and large caused by extraordinary increases in wages of organized labor over the past several years. It should be noted, however, that the wages of unskilled labor in the last decade have been lagging behind corporate profits. On the other hand, the wage demands of organized labor, particularly in our basic industries and the exercise of its power, have had little regard for the productivity of labor, and therefore, it must be of vital concern to us at this crucial time. The necessity for price and wage stabilization is long overdue: the meant os collective bargaining as applied today are inadequate; and the continuing series of strikes are irreparably hurting this nation. For a great many of these conflicts, some form of arbitration in the area of wage bargains must be applied. In addition, the question of antitrust violations in the area of labor should also be looked into just as hard as they should be looked into in the area of various industries, including the multinational complexes. Without applying ourselves to these problems, and without a speedy resolution, there is little hope for our recovering from the blows which we suffer in the world marketplace.

With continued inflation at home, only partly mitigated by monetary and fiscal policies, and without these specific policies to moderate wage and price increases, we shall continue to persist in deficit in the nation's balance of international payments. It would seem to me that the price and wage stability at home and increased productivity are the first and foremost considerations at this time to achieve the desired results.

Respectfully yours,

E. S. FINLEY, *President.*

U.S. SENATE,
Washington, D.C., July 12, 1971.

Mr. E. S. FINLEY,
President, International Commodities Export Corp.,
New York, N.Y.

DEAR MR. FINLEY: This is to acknowledge receipt of your July 7, 1971 letter in which you enclosed a copy of your communication to Secretary of Commerce Maurice H. Stans relative to a proposal to liberalize anti-trust laws insofar as foreign trade is concerned.

I am grateful to you for giving me the benefit of your thinking on this matter, and send you my kindest wishes.

With best wishes,

Sincerely yours,

SAM J. ERVIN, Jr.

U.S. SENATE,
Washington, D.C., July 13, 1971.

Mr. E. S. FINLEY,
President, International Commodities Export Corp.,
New York, N.Y.

DEAR MR. FINLEY: Thank you for your letter, and for the enclosure written to Secretary Stans. I, too, share your concern. You can be assured that I will consider your views when this matter comes to the Senate for consideration.

With best wishes,

Sincerely,

HUGH SCOTT.

U.S. SENATE,
COMMITTEE ON GOVERNMENT OPERATIONS,
Washington, D.C., July 14, 1971.

Mr. E. S. FINLEY,
President, International Commodities Export Corp.,
New York, N.Y.

DEAR MR. FINLEY: Thank you for your recent letter concerning the Administration's anti-trust policies.

You may be assured that I shall give this matter my closest attention when it comes before the Senate.

Thank you for taking your time to advise me of your views.

With best regards,

Sincerely yours,

EDWARD J. GURNEY.

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C., July 19, 1971.

Mr. E. S. FINLEY,
President, International Commodities Export Corp.,
New York, N.Y.

DEAR MR. FINLEY: Thank you for sending me a copy of your thoughtful letter to Secretary Stans.

The issue of antitrust reform is one of first importance. I have introduced legislation to create a commission to review and recommend revision of the antitrust laws. It is my hope that such a commission can convene and study a broad range of economic and antitrust questions before specific items of legislation are enacted. In the course of such a study, full consideration should be given to the type of concerns voiced in your letter.

I appreciate having the benefits of your thoughts and experience.

With best wishes,

Sincerely,

JACOB K. JAVITS.

U.S. SENATE,
COMMITTEE ON PUBLIC WORKS,
Washington, D.C., July 22, 1971.

Mr. E. S. FINLEY,
President, International Commodities Export Corp.,
New York, N.Y.

DEAR MR. FINLEY: Thank you for your letter and copy of your letter to Secretary Stans. I appreciate your keeping me informed.

Sincerely,

JOHN V. TUNNEY.

THE SECRETARY OF COMMERCE,
Washington, D.C., August 3, 1971.

Mr. E. S. FINLEY,
President, International Commodities Export Corp.,
New York, N.Y.

DEAR MR. FINLEY: I have read with interest your letter of July 6 commenting on my remarks before a subcommittee of the Joint Economic Committee last month during hearings on some of the problems the United States faces in its international economic relationships.

References to antitrust in my statement to the subcommittee were necessarily brief in view of the broad scope of the subject matter under consideration. I was mainly concerned to get across the point that foreign governments utilize antitrust as a flexible trade promotion device. In the light of our present balance of payments problems, resulting partly from a deteriorating trade position, I felt we might well reconsider some of our present policies and practices ranging across the area of competition regulation.

Although I did not address myself directly to the Webb-Pomerene Act, I am inclined to the view that the Act has not been utilized to its full potential as an effective instrument for the promotion of exports. This concerns me because joint exporting is being successfully employed in all of the major exporting countries. Two of our strongest competitors—Japan and Germany—encourage export associations and cartels and have large numbers of such joint export groups which operate under broad exemptions from their respective national antitrust laws. Therefore, while the Webb-Pomerene Act may not be the answer to all of the problems of foreign marketing, it can be a useful tool, given proper implementation and with appropriate safeguards.

Other steps should be taken to improve our export competitiveness. The proposal now before Congress to provide additional export financing facilities to the Export-Import Bank is of major importance in this respect. Our exporters also attach great importance to the Administration's proposal to permit the establishment of Domestic International Sales Corporations which would be entitled to a tax deferral privilege on their export income. Another proposal, on which the House and Senate are currently holding hearings, would authorize the Department of Commerce to support private industry participation in voluntary international standardization activities so as to insure the acceptability of U.S. made goods in world markets from the standpoint of measurement and performance requirements. These measures, together with the Administration's anti-inflation policy, will help overcome our present higher unit labor costs.

I want to congratulate you on your company's outstanding export performance, and hope that you will continue to let us have the benefit of your views and experience.

Sincerely,

MAURICE H. STANS.

VIRGINIA PORT AUTHORITY,
AGENCY OF THE COMMONWEALTH OF VIRGINIA,
Tokyo, Japan, January 19, 1972.

Hon. WARREN MAGNUSON,
U.S. Senate,
Washington, D.C.

DEAR SENATOR MAGNUSON: As I explained in my last letter to you, there is an association of the American Chambers of Commerce in the Far East and Australia/New Zealand known as the Asia Pacific Council of American Chambers of Commerce (APCAC).

At a meeting a few days ago of the APCAC Liaison Committee of the American Chamber of Commerce in Japan, your Senate Bill 2754, a bill to authorize the Secretary of Commerce to engage in certain export expansion activities, was discussed at length. It appeared to be the consensus of the many members present that they approved in general this bill and were in favor of supporting it as associations and individuals.

I thought you'd like to know this.

Sincerely,

W. J. YOUNG,
Director for Far East.

STATEMENT BY

EMIL SHERER FINLEY

PRESIDENT AND CHIEF EXECUTIVE OFFICER

INTERNATIONAL COMMODITIES EXPORT COMPANY

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

JULY 25, 1980

Mr. Chairman:

My name is Emil Sherer Finley. I am President and Chief Executive Officer of the International Commodities Export Company, a firm which I founded over 30 years ago and which has become a prominent exporter of agricultural chemicals, with an annual volume close to a quarter of a billion dollars.

May I first express my appreciation for the opportunity to appear today before you and your committee to present my views and those of my company in connection with S.2718.

Nobody can question the importance of increased exports to our economy. While those of the other industrialized countries frequently represent 20 to 40% of their gross national product, ours represent barely 10%. With a continuing annual trade deficit running into many billions of dollars, it is understandable that all of us are deeply concerned. Unfortunately, some well-meaning legislators and certain private interests are creating a climate of panic to gain quick acceptance of solutions which eventually will hurt our country much more than the current deficits. Indeed, I am sad to note that Congress can only come up with a bill to encourage the creation of U.S. "trading companies" and expanded antitrust exemption of U.S. export activities by amendment of the Webb-Pomerene Act.

These voices are simply saying that if we will allow virtually unbridled price fixing, with immunity under antitrust laws, our failure to export a substantial share of our gross national product will have been corrected. I am chagrined by this bill as a business man, as an exporter, as an entrepreneur and as an economist.

For the past two decades, we have been told over and over again that billions of dollars worth of potential annual export business is neglected because small and medium size producers are unable to develop foreign markets. We have also been told that only one in ten U.S. manufacturing firms sells abroad. We are told that this new legislation would help materially to get these small producers to export. The fallacy of it is that the world has changed in the last quarter of a century and even the developing and under-developed countries now have local industries which can produce the needed goods we are talking about and therefore, in most cases, make it almost impossible for the U.S. to succeed in such exports. We are also told that important service contracts abroad elude our major contractors.

But there is nothing in our antitrust laws that prevents our major contractors to join together in projects.

This highly publicized bill, S.2718, tells us that we should go the OPEC way. My personal experience tells me otherwise. One measure of the success of my company is the fact that, since 1948, U.S. exports have gone up 1400%, while our own exports have gone up 9200%. We did not need any protective devices or legislation to do this. We were able to do it because we paid close attention to the forces of supply and demand and because we were willing to be competitive. Surely, we have shown that we are in favor of expanding U.S. exports by making this contribution over the years. We are in favor of further expansion, but we believe that such expansion should be on the basis of increased, and not restricted, competition.

The purpose of my coming here is to warn this committee of the dangerous features of any expansion of the antitrust exemptions under the Webb-Pomerene Act. I have testified in 1978 before the National Commission for the Review of Antitrust Laws and Procedures. I have also presented a lengthy policy statement before the National Journal's Policy Forum in 1979.

I have testified before the Subcommittee on Foreign Commerce of the Committee on Commerce on S.2754 in January, 1972. I request that all of these statements and enclosures be included in the hearing record.

In many of these papers, I have described typical Webb-Pomerene associations and have shown that, contrary to the generally accepted concept, the expansion of the Webb-Pomerene Act's antitrust exemption will not stimulate an increase in our exports. As we all know, this exemption was intended by Congress originally to enable small U.S. businesses to compete against the then prevailing European cartels. Contrary to this intent, this exemption has enabled, in fact, large U.S. companies to form cartels of their own, most often in the areas where there is practically no foreign competition. Moreover, this exemption has discouraged, and not encouraged, competition and has led, and continues to lead, to further U.S. cartelization and control over the flow of U.S. exports. If exports are being restrained now, as they certainly are, they would be restrained even more if such bills were to pass. The most disturbing fact about all this is that the Webb-Pomerene associations benefitting from antitrust exemptions are composed mostly of members which, together, dominate also our domestic scene. Their immunized actions taken with respect to export pricing and setting quotas have a direct and adverse effect on the domestic market which they are able to influence simultaneously. Thus, our farmer, our worker, our tradesman and, of course, our consumer, is forced to pay higher prices for the product.

The 1967 FTC study and hearings on the operation of Webb-Pomerene conducted by the U.S. Senate demonstrated how little that Act and its antitrust exemption have done to encourage U.S. exports since 1916. To stimulate U.S. exports, we do not need the continuation and expansion of an act which encourages anti-competitive behavior.

We need, instead, to recognize that our failure to gain our appropriate share of the export market is due to this very anti-competitiveness which, in turn, contributes dramatically to our overall declining productivity, inflation and much, much higher domestic prices of products.

The companies who need it the least benefit from the anti-competitive blessing of Webb-Pomerene and have produced hordes of witnesses to testify about the desirability of continuing that blessing. The general public who will be adversely affected cannot usually muster the resources to make its voice heard.

Our export markets will expand with more - not less - competition. Companies such as ours can contribute to the give and take of the marketplace if they are allowed to.

As my National Journal article illustrates graphically, the Webb-Pomerene associations operate by excluding such companies as ours from the marketplace so that prices can be set for export and domestically production can be restricted.

The bill would also permit banks, bank holding companies and international banking corporations to own export trading companies. The arguments for doing this point to the fact that bank organizations are able to reach out to a large number of small and medium size companies who may manufacture exportable products. My question is -- why don't these banks reach out to these companies now? Or for the past 25 years without this legislation? The other argument for the banks to participate is that their international branches and correspondents are in an excellent position to identify potential foreign markets and customers. Surely, they have been doing this for many decades and any exporter or manufacturer can get the banks to give them that information. Why is it, then, that they are asking for this legislation? My suspicion is that the power of the banks would be enhanced without corresponding contribution toward the expansion of exports, but with dramatic increase in the leverage which the banks would have to control and restrict exports to achieve their specific objectives and reducing the competition between the banks and making it even less likely for an independent exporter to be able to obtain suitable financing.

It is noteworthy that a number of commissioners of the National Commission for the Review of Antitrust Laws and Procedures favored outright repeal of the Webb-Pomerene Act. Their instinct was right. It is increased competition and increased productivity of capital and labor that represent the foundations on which to build an expanding export trade. It is the essence of free trade and of America. We should all keep these points in mind when the decisions are made on the new export policy of our country.

July 27, 1978

Statement by E. S. Finley
Before the National Commission for
the Review of Antitrust Laws and Procedures

De-Mything Webb-Pomerene

A Statement by Emil Sherer Finley

I came here to talk about Webb-Pomerene associations and their effects on foreign and domestic trade. In 30 years of experience in the export business, I have dealt and competed with six Webb-Pomerene associations. I have seen what they do and the effects of their actions.

Two Myths

There are Two Myths about these associations that everyone who comes in contact with them knows have nothing to do with reality.

The First Myth: Webb-Pomerene associations do not restrain domestic trade in the United States. That is not a fact. They do -- and always do.

Second: Webb-Pomerene associations are necessary for American companies and industries to compete with foreign cartels producing the same goods. That is not true in practice -- or as a matter of logic. There may be one exception to my fiat, but the exception is rare.

The First Myth

Turning to the First Myth: Webb-Pomerene associations are mostly found in industries producing basic and homogenous products. With most of these products, there is a "traditional" relationship between the domestic price and export price (usually a percentage discount). In other instances, the export market is viewed as a way to sell off "surplus." In both cases there is bound to be a price stabilizing effect domestically. Thus, when major producers set export prices in unison, they know full well that they are either setting a level for domestic prices or helping to stabilize domestic prices by eliminating "over-production" in the United States.

Similarly, when Webb-Pomerene members set export and production quotas they impact domestic production and restrict domestic competition; for they are saying who gets rid of what "surplus" or who is going to make the extra profit. We know that associations even stay out of foreign markets, on occasions, in order to "influence" domestic prices. The situation is exacerbated when the members of Webb-Pomerene associations are also large multinational companies with production or buying facilities abroad. The consideration of sales of their overseas production necessarily helps determine what Webb-Pomerene members will urge on each other.

When -- as is the rule -- the associations are composed of the large companies dominating domestic production of a product, a monopolizing effect in the United States is bound to exist. By monopolizing the outlet for "surplus" production, the associated companies can thereby discourage entrants in domestic markets as well as discourage and eliminate export competitors.

The Second Myth

Turning to the Second Myth: The notion that Webb-Pomerene cartels are needed to compete with foreign cartels. Both logic and experience tell us that this is not true -- with one very limited exception.

The logical fallacy of the Second Myth can be illustrated simply. Suppose a foreign cartel is fixing prices and quotas for its members on Commodity X for Australia. The price is $100 per unit. There is no reason on earth, except possibly cost factors, why an American Webb-Pomerene association is needed for any member of it to meet or better $100 per unit. The way, logically, to compete more vigorously against the $100 price is to have as many producers of Commodity X go out and battle it out. Economists tell us -- logic tells us -- that the fewer the competitors the less likely there will be price competition. American cartels are, in fact, an

66-942 0 - 80 - 11

invitation not to compete with foreigners: They are the breeding ground for tacit understandings -- if not direct commitments with foreign cartels. And quotas among the foreign cartels don't disadvantage Americans; indeed, sometimes they create a price rigidity among the foreigners for Americans to exploit by price competition. Therefore, we just don't need our own Webb-Pomerene cartels to fight foreign quotaing.

In practice, American Webb-Pomerene associations are not truly designed to promote vigorous competition with foreigners but to stabilize prices. It is no accident that when each of the Webb-Pomerene associations, with which I have come in contact, came into being or expanded, each was heralded with fanfares about expected price stabilization and anticipated rising prices -- domestically and abroad.

Indeed, quite often, foreign cartels and producers openly welcome the Webb-Pomerene cartel. The foreign "reviews" are always "mixed" when one of these associations comes into being or expands. Big foreign producers are usually quite happy, but foreign "traders" and importers unhappy. For example, Green Markets, a fertilizer market trade weekly published by McGraw-Hill, reported that Brazilian traders and users were quite unhappy when the Phosphate Chemical [Webb-Pomerene] Association -- "Phoschem" -- recently expanded its membership. The July 17, 1978, edition*

* I append the article as an exhibit.

quoted one Brazilian "source" as saying it was "rotten." Another Brazilian was reported to have said, "We expect drastic increases in U.S. prices." Another said that it was likely to "jeopardize" the "import volume." (Brazil is a major importing market for American fertilizers.) The article further reported: "One Canadian producer thinks higher US export prices might even stabilize the Canadian market and help his company." It said also: "An official of the South African Fertilizer Society [a cartel] said stable prices and a better market would probably result." The article reported: "Most European producers are optimistic. They feel that as well as raising prices, the Phoschem expansion will provide the market stability which has been absent in recent months. One source, however, is slightly more skeptical. He feels that the enlarged Phoschem will be fine if it exerts a regulatory influence on the market. But it will prove less interesting if it is merely a sales mechanism through which US producers will channel their products in a fluctuating market."

That's reality. Price stabilization; price-increases; hoped-for world-wide "regulation": not competition. Do not be beguiled by theories of those not in the market place. Read what businessmen say.

Back in 1967, the Federal Trade Commission's Bureau of Economics Report, Webb-Pomerene Association: A 50-Year Review, (July 14, 1967) ("the 1967 FTC Report")* spoke of the utter failure of Webb-Pomerene associations to promote America's share of foreign markets. Nothing has changed. The truth is, if you scratch a Webb-Pomerene member a bit, he only bleeds price fixing and share-of-market stabilization.

There is one possible exception -- but I've never run across it. Where small producers cannot economically enter a market -- based on costs related to size -- there may be room for an American cartel.

The 1967 FTC Report confirms my experience. Here is the fully documented conclusion about what the FTC reporters found in 1967 and surely would find today:

> "In summary, Webb-Pomerene activity is limited to comparatively few associations handling a limited range of products, and the number of beneficiaries from such activity is also quite small.*** These members [of Webb-Pomerene associations], for the most part, were drawn from the upper reaches of the business population and, at the same time, were the major beneficiaries of Webb-Pomerene assistance.*** Fifty years of experience, including a recent period of uninterrupted trade expansion, reveals the

* Printed as an Addendum in Hearings before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, U.S. Senate, 90th Congress, 1st Session, pursuant to S. Res. 26.

> Webb-Pomerene Act as no panacea for the expansion of foreign trade by small business and, indeed, points to the conclusion that it plays a very minor role in overall U.S. exports." (FTC Report, pp. 317-18).

It is no surprise to me that the Assistant Secretary of Commerce, Mr. Frank A. Weil, now reports to you a "slow, but fairly steady decline in the number of registered associations." But in view of the fact that the Webb-Pomerene Export Trade Act of 1918 was aimed at facilitating the entry of small firms with foreign commerce -- as Mr. Weil reports -- into foreign commerce, I cannot truly see how he can now conclude that the considerations for allowing Webb-Pomerene Act associations back in 1916 call for their expansion today. The fact of the matter is that since the Webb-Pomerene Act of 1918 was passed, the United States has become a major industrial and commercial power. Instead of numerous small firms in exporting industries, we find a few giant producers, who can and do dominate world and domestic markets. Against these firms, we find few, if any, effective foreign cartels. With due respect, Mr. Weil's premise for major expansion of Webb-Pomerene cartels no longer exists.

We have heard from Mr. Weil and from others that Webb-Pomerene associations are needed for large-scale project bidding. The notion is that the Westinghouses and the General Electrics and the General Motors are all handicapped because they cannot get together to put forward a single bid for a project against foreign consortia. But a Webb-Pomerene association isn't needed for such a project bidding. First, getting together for a single project, means, or should mean, producers of different products or services coming together -- not Westinghouse and General Electric dividing up a share of the same phase of a project. Second, all that is needed -- and as happens every day -- is a single contractor places a bid backed by sub-contracts. Thus, we are being subjected to the creation of another myth.

Conclusion and Suggestions

The fact is, as Mr. Weil reports, that neither the Justice Department nor private parties have been able to prosecute Webb-Pomerene associations with any vigor in the last 25 years. It is much too costly for the private sector. FTC registration and questionnaires -- I submit -- are not enough.

Since Webb-Pomerene associations (by and large), are the creation and darlings of the very large and powerful corporations, and since they necessarily affect interstate commerce in a deleterious way and rarely promote our foreign trade, the procedures under the Act should be changed. Instead of automatic registration, the burden should be placed upon would-be registrants to show -- under cost-related and market-forecasting criteria -- that an association is needed before the association is allowed to function. Open hearings should be held by the FTC and specific findings should be required. Multinational corporations should be excluded from membership in these Webb-Pomerene cartels. Experience and logic dictate that those who would eliminate competition ought to be put to the test that they warrant exemption from our antitrust laws.

GREEN MARKETS

Vol. 2 Number 29
July 17, 1978

***

Appendix to Statement of E. S. Finley

Phoschem fallout—"rotten", to acceptance

The formal announcement last week of Phoschem's expansion came as no surprise to the US and foreign fertilizer industries, since word had circulated in the industry prior to the actual revelation. Reactions among producers and traders have been generally subdued, with only Brazilian traders registering overtly negative feelings.

"Rotten," says one Brazilian source. "We expect a drastic increase in US prices," says another. "It could easily jeopardize our import volume," according to one Brazilian analyst. Brazil normally imports 70% of its phosphate requirements in the second half of the year. Brazilian industry associations have yet to comment publicly on the Phoschem move.

But in the US, Canada, Europe and South Africa, the prevailing attitude was one of "wait and see." The confident predictions of producers notwithstanding, knowledgeable sources pointed to Phoschem's history of expansion and withdrawal, and some were frankly skeptical about how long the new arrangement would last. "Beker left before because they felt they weren't getting their fair share—so did Agrico. Who's to say they won't pull out again if they get disgruntled?" queried one New York trader.

Yet along with these doubts most market sources agree that the price stability resulting from the move will be good for the industry as a whole. "If Phoschem does it right, it may succeed," says one source. "Gardinier may even join," he adds. (However, Gardinier discounted (Continued on page 2)

(Phoschem continued from page 1)
the speculation.)

"Phoschem will be foolish if it tries to push the price of DAP much above $135," says one trader. "The Europeans even feel anything over $130 is dangerous," he adds.

Yet the midweek price of DAP was pushing past the $135-mt mark, with TSP more steady at $94-mt (see Market Watch). The DAP prices probably reflected anticipation of Phoschem's new price list.

The Brazilians aside, other interested international observers see only minor repercussions stemming from Phoschem's expansion. One Canadian producer thinks higher US export prices might even stabilize the Canadian market and help his company. Another Canadian source wonders whether the US companies would consider his firm as part of the Phoschem market. "Some may continue to sell directly in Canada," he says.

Triomf sees little impact

In South Africa, industry sources view the expansion with interest but see little impact on their country's exports. An official of the South African Fertilizer Society said stable prices and a better market would probably result, but saw no countermoves coming from other major international suppliers.

A source at Triomf did note with respect to phosacid that there may be some price differential between US prices and South Africa's. But inasmuch as Phoschem will not be the leading supplier of phosacid, the differential—which will be small—will harm neither Triomf nor any other South African producer.

European reaction mixed

Most European producers are optimistic. They feel that as well as raising prices, the Phoschem expansion will provide the market stability which has been absent in recent months. One source, however, is slightly more skeptical. He feels that the enlarged Phoschem will be fine if it exerts a regulatory influence on the market. But it will prove less interesting if it is merely a sales mechanism through which US producers will channel their products in a fluctuating market, he says.

European brokers, like their American counterparts, are not overly enthused by Phoschem's expansion. One trader describes the group as a blatant cartel, and foresees it diverting considerable business away from brokers.

Although producers dismiss the possibility of anti-trust action against Phoschem some traders feel differently. While they acknowledge that the possibility of government action is slim, it does exist, they contend. A source at the US Dept. of Justice points out that an organization such as Phoschem risks anti-trust action in two areas: 1) if there is a "spillover" in the export price area to the domestic market, and 2) if Phoschem engages in any kind of joint action with an overseas cartel. The Justice Dept. has in the past brought suit against violators of the Webb-Pomerine Act, the legislation governing associations such as Phoschem.

But in the US, producers' sentiment was perhaps summed up by an executive of one of the new member companies. When asked if the expansion reflected any long-term erosion of the market, he replied, "The move has nothing to do with a strong or weak market, but the value of an export association, which I happen to believe in."

The Realities of United States Foreign Trade and The Fictions Of Our Cartel Advocates

by Emil Sherer Finley

Emil Sherer Finley is the founder, president and chief executive officer of International Commodities Export Company (ICEC), a division of ACLI International.

Painful facts make fools of some of us all of the time, and almost all of us some of the time. When all the known evidence says "green," some of us proclaim "red" in the hope of finding some evidence of red. When we need fairness, some of us would impose judges who have pre-judged our cases. When we have proof that people have hurt us, some of us would reward them lest they not reform. When we have to know the facts, most all of us resort at some stage to fictions to shelter us from the unpleasant reality. When in doubt, we quite frequently legislate.

Not that truth, beauty and right action don't often emerge and win out. It is the glory of free speech and a democratic process that quite often pigheaded wrongness gets defeated in the marketplace of ideas and therefore in the halls of Congress. It involves a struggle that is rarely inviting. But we have to be existentialists, if not optimists; for to be otherwise is to leave the field by default to the beguiled, the misled and, alas, the greedy. Conscience requires a fight.

In trying to deal with some woes of our foreign trade, we have been besieged and somewhat beguiled by the misled and, yes, the greedy. The cartel advocates are in the marketplace to overcome painful facts with fictions. Realities, which once seen would help us to deal rationally with the painful facts, are lost. And some very good men have made some very wrong proposals.

PAINFUL FACTS AND FOOLISH REACTIONS

The most painful facts of our foreign trade are that in six out of the last eight years the United States has had a deficit balance of foreign payments; and inflation has boomed along, with the cheapened dollar only exacerbating the flow of money out by reducing our buying power. Last year we had a deficit in our balance of trade of $30 billion.

We are not used to such things. All was right with our trade in this century up to 1971. Because we get worried it becomes time to panic or to avoid real panic by frenzied action. It becomes time to look for quick solutions. And it becomes time to treat painful facts as if they have nothing to do with our own faults, for self-blame is still more painful. We begin to create myths from long-ago half-truths or from no-truths. Thus, it must be that the foreigners at our gates are conspiring against us and are taking advantage of our good nature and fairness. They bribe better or bigger; they are more organized in combating our poor, fractionalized industries. Indeed, we see grand cartels, government sponsored, taking away our business; and all the while our Justice Department's Antitrust Division and our notions of free competition do not allow us to fight back. Foreigners come here with impunity, and we go nowhere but that we are faced with stifling, organized resistance in Washington and unfair, subsidized competition from the outsiders. The answer—so we are then told—is to fight back with the same weapons. Let us create our own cartels. There are even suggestions that we were wrong in this post-Watergate era to demand that our industries stop bribing foreign officials. Nonsense: all of this.

One need not take seriously the all-too-serious "jokes" about the need to out-bribe our foreign competitors. In the long run, self-defeating corruption cannot be justified. If our society must save itself by being corrupt, then it is not worth saving. I won't dote, but the fact is that Americans can compete successfully without bribing. If there is a cartel that is needed, it is a cartel that has one rule: thou shalt not bribe.

As to the drive to create more cartels, that requires some analysis, for it is not plainly immoral and becomes amoral only when reality catches up with the fictions that are used to support the cry of more cartels.

Here is the reality.

THE WEBB-POMERENE ACT

There is already in existence in the United States a piece of cartel-creating legislation dating from 1918, the Webb-Pomerene Act. The Webb Act allows for the creation of associations of producers of goods solely for the purpose of engaging in export trade. The associations can operate if they register with the Federal Trade Commission and as long as they do not restrain the export trade of any "domestic competitor." Webb associations are not supposed to "enter into any agreement, understanding or conspiracy, or do any act which artificially or intentionally enhances or depresses prices within the United States . . . or which substantially lessens competition within the United States or otherwise restrains trade therein." Under a consistent interpretation by the FTC and as followed by the courts, Webb associations can and do fix prices and set up quotas.

"Under a consistent interpretation by the FTC, and as followed by the courts, Webb associations can and do fix prices and set up quotas."

While the original vision of the Congress and of the Federal Trade Commission Report that recommended the Webb Act saw the true function of the association as a cost-reducing expediter, there is no question that the role of price-fixer and market allocater has been the predominant feature of Webb associations over the years. In brief, Webb associations have taken on the usual roles of cartels. Thus, we have in America government sanctioned cartels that are exempted in the *export* trade from the normal operation of the antitrust laws.

The prime justification back in 1918 for Webb associations was that they were needed by small companies in order to compete with foreign subsidized businesses and cartels. At the time, American corporations were only beginning to become factors in world commerce. The theory was that associations could cut costs and thus would allow American corporations to compete successfully on the basis of price as well as quality of goods.

WEBB ACT PERFORMANCE

In 1967, the Federal Trade Commission completed a study—an empirical study—of Webb associations over their first 50 years. The report found that the Webb Act had failed to promote United States exports in any significant way during those 50 years. The 1967 FTC study revealed that the export associations that succeeded for any length of time were those involved in industries where the members were leaders of a domestic oligopoly, were dominant factors in the foreign trade and dealt with a homogeneous product. The small company did not take advantage of the Webb-Pomerene Act. Of the 465 members of Webb associations during the period between 1958 and 1962, for example, only 17 per cent had assets of $1,000,000 or less, and only 22 per cent had assets of between $1,000,000 and $5,000,000. The large firms counted for about 80 per cent of all exports by Webb associations. There were never any more than 57 registered associations in any one year, and some companies were members of more than one association. During that same period of 1958 to 1962, Webb associations accounted for only 2.4 per cent of total United States dollar exports. The 1967 FTC Report concluded:

> "In summary, Webb-Pomerene activity is limited to comparatively few associations handling a limited range of products, and the number of beneficiaries from such activity is also quite small. . . . These members [of Webb-Pomerene associations], for the most part, were drawn from the upper reaches of the business population and, at the same time, were the major beneficiaries of Webb-Pomerene assistance. . . . Fifty years of experience, including a recent period of uninterrupted trade expansion, reveals the Webb-Pomerene Act as no panacea for the expansion of foreign trade by small business and, indeed, points to the conclusion that it plays a very minor role in over-all U.S. exports." (FTC Report, pp. 317-18.)

The data available since 1967 proves that nothing has changed. If anything, the utter failure of our legalized cartels in promoting American exports is more pronounced. By 1976, only 1.5 per cent of the total U.S. exports came through Webb associations and the number of registered Webb associations was only 33. Today, there are 35 registered associations with 338 members, many of which are in more than one association. The registration rolls at the FTC make it plain that the firms that benefit most from the Webb Act are still those that market homogeneous products and dominate their industries. I have taken a look at the nature of the products of the 35 currently registered Webb Act associations. Only four of them seem to be in industries where there are non-homogeneous products.

As of 1976, a total of six Webb associations accounted for nearly two-thirds of the dollar value of all Webb-assisted exports. These six associations (plus one other) are the only presently registered associations that were in existence in 1962. Four of the big six produce homogeneous goods: dried fruits (2), rice products and paper. The other two are both film-industry associations, formed by the 10 dominant firms in the industry.

". . . there is no question that the role of price-fixer and market allocater has been the predominant feature of Webb associations over the years. In brief, Webb associations have taken on the usual roles of cartels."

The pattern is clear. Webb associations have benefited those firms that need help the least, and the firms use the associations not to promote volume but to stabilize export prices. Since the future (and past strength) of United States exports lies in complex, differentiated products, Webb associations are not likely to play any larger role in the United States export picture than they have in the past.

THE EFFECT ON DOMESTIC TRADE

Although irrelevant to small United States companies and insignificant in the scheme of over-all exports, Webb associations have had a deleterious effect on domestic pricing and competition.

With most homogeneous products there is a traditional relationship between the domestic price and export price (usually a percentage "discount" on the domestic price). Usually, the export market is viewed as a way to sell off "surplus" and ward off domestic price deterioration. As a result, export price fixing is always bound to mean price fixing or stabilization in the domestic market. We cannot be blind to what common sense screams at us: When major producers of the same or virtually the same product set export prices in unison and "predict" what they will be for the future, they know necessarily that they are helping to set a level for domestic prices and are helping to stabilize these prices.

"When major producers of the same or virtually the same product set export prices in unison and predict what they will be for the future, they know necessarily that they are helping to set a level for domestic prices and are helping to stabilize these prices."

There is also a domestic monopolizing aspect to Webb associations. Successful Webb Act associations dealing in undifferentiated products control or dominate the "surplus" export market; and that surplus market often is the difference between a profitable trading year or an unprofitable one. Even when large producers remain outside the cartel, the road to survival or entry of the small firm is more difficult.

That Webb-Pomerene cartels are needed to fight foreign cartels has always been grounded in a theoretical fallacy and no real truth. The existence of foreign cartels that fix prices theoretically could only *help* American competition. They could only create price umbrellas for their American competition. In the United States, for example, when these Webb-Pomerene Act associations come into being, the large American companies outside the cartels are quite happy because they can easily underprice the rigid cartel or the cartel sets a price that the competitors gladly follow. Indeed, it is a commonplace in the true market that the best policemen of Webb-Pomerene pricing are those outside the cartel.

In fact, as the FTC found in 1967, large oligopolistic American corporations do not need the associations to compete with any foreign business concern or groups of concerns. Today American companies dominate the fields where Webb associations operate successfully. By stabilizing prices and establishing quotas, the members of Webb associations do not compete in any traditional sense with the foreigners. If they wanted to compete for business, they would not be fixing prices, they would be setting prices independently based on costs and reasonable profit. And dealing mostly in homogeneous products and in dominated markets, Webb association members do not compete unless they compete on prices or services that amount to price savings.

THE REACTION ABROAD

It is a fact that Webb associations are welcomed by their supposed enemies abroad. When Webb associations are created or expand, the foreign competitors hail the event. The "reviews" abroad become "mixed" only because the *purchasers* of the products—usually found in undeveloped nations—know that they can expect increases in the United States prices and stabilized prices everywhere. All one has to do—if one really wants to find out what the reality is—is to read the trade journals when one of these Webb Act associations is created or increases its membership.

For example, *Green Markets*, a fertilizer market trade weekly published by McGraw-Hill, reported that Brazilian traders and users were quite unhappy when the Phosphate Chemical (Webb-Pomerene) Association—"Phoschem"—expanded its membership of fertilizer producers last year. The July 17, 1978, edition quoted one Brazilian "source" as saying it was "rotten." Another Brazilian was reported to have said, "We expect drastic increases in U.S. prices." Another said that it was likely to "jeopardize" the "import volume." Brazil is a major importing market for American fertilizers. But the article further reported: "One Canadian *producer* thinks higher U.S. export prices might even stabilize the Canadian market and help his company." It said also: "An official of the South African Fertilizer Society [a cartel] said stable prices and a better market would probably result." The article noted: "Most European producers are optimistic. They feel that as well as raising prices, the Phoschem expansion will provide the market stability which has been absent in recent months."

That's reality. What Webb Act cartels are about are price stabilization, price-increases, production control, hoped-for worldwide "regulation," not competition and vigorous promotion of American products. The result is less trade for us—controls, controls, controls for the sake of prices. It is no accident that since Phoschem's expansion, the prices of its products—export and domestic—have gone up about 50 per cent and that hike does not reflect cost increases. Inflation guidelines are ignored. And so the theories of those not in the marketplace are exposed as fantasies. Read what businessmen say; listen to us in the trade, who know our "customers."

"By stabilizing prices and establishing quotas, the members of Webb associations do not compete in any traditional sense with the foreigners. If they wanted to compete for business, they would not be fixing prices; they would be setting prices independently based on costs and reasonable profit."

SEVERAL OTHER REALITIES

Furthermore, the function of selling agent is not best done by a Webb-Pomerene Act association or, in fact, often done by the associations. Again, a little investigation will show that Webb association members do their own selling and their own marketing and use the association offices only as a conduit and a means to prevent competition. According to the FTC, only eight associations reported sales agencies in the United States and only six reported overseas agencies in 1976. Moreover, only 12 directly assisted exports, and these exports accounted for less than 17 per cent of dollar Webb-assisted exports in 1976. As the FTC has found: All the sales functions can be, and have been done historically, with more vigor and with a lot more results by independent exporters. Agreed market division means complacency and no real promotion. Webb associations beget an atmosphere of "cordiality" with foreign competitors that is indistinguishable from gentlemen's agreements.

Moreover, it is a fact that in many industries where Webb associations exist, there is no real foreign competition. Even if you believe the answers that the associations have supplied to the annual FTC questionnaires, Webb Act associations have hardly been fighting foreign cartels. Only 11 out of the presently registered associations have claimed competition from cartels or government-sponsored organizations. And their answers have to be suspect; there is, at least, hyperbole in them.

Again Phoschem provides a good example. Its answers to the FTC claim competition from overseas cartels and foreign government organizations. In the two major products that it deals with, diammonium phosphate and triple superphosphate ("DAP" and "TSP"), Phoschem has no significant competition in most world markets. And, by some "magic," Phoschem will not offer much material to those few places where the foreign production has had its "traditional" sway. Over-all, the Americans dominate what they choose to dominate. They are the giants. In 1977, for example, the world export trade in DAP and a related product totaled 1,870,000 tons (of P^2O^5). The American share of that market was 1,367,500 tons (of P^2O^5). In 1977, the total world export of TSP totaled 996,500 tons (of P^2O^5). American exports accounted for 504,600 tons (of P^2O^5).

Thus, there is no need for Webb-Pomerene Act associations in fields such as the one with which Phoschem is involved; they serve nothing but anticompetitive ends. And Phoschem, I submit, is typical.

Our problems stemming from the Webb Act cronyism and artificial price structuring are exacerbated by still another development unforeseen in 1918: Multinational corporations are found in good number among Webb associations. And they aren't merely multinationals in unrelated businesses; many Webb association members have foreign subsidiaries that (1) buy from the Webb associations and (2), believe it or not, compete with the Webb associations—without the slightest compunction and without protest within the associations. There hasn't been a word of criticism from the Federal Trade Commission. Necessarily, where multinationals participate in American price-fixing and quota-setting, something beside the promotion of American exports has to be involved. In fact and in effect, our foreign competitors participate in our price-fixing decisions and their interest is not in "selling American."

Factually, foreign buying "cartels" have come about in response to price-fixing selling cartels—our Webb associations. There is no evidence that foreign buying cartels or foreign government purchasers have hurt United States exports or forced anybody to sell anything other than at a fair and profitable price. There is no evidence that they have had an unfair bargaining position vis-a-vis American exporters. We in the market know that the reality is that government agencies are most often easier to deal with than multiple foreign purchasers. It is not a fact that we sell cheaper to government sponsored buyers. For example, Asian government agencies and buying cartels traditionally pay higher prices than do the multiple private purchasers in Brazil.

When you are concerned with standardized products in demand—the products that are the prime items for Webb-Pomerene associations—there are, in fact, no barriers with which the Webb-Pomerene Act has to deal. With these products, there are producing nations and there are consuming nations. Consuming nations are always disturbed by cartelization, because they know that that means higher prices (and in the instance of fertilizers and Phoschem, for example, higher food prices for their populations) The hurtful barriers come, if at all, from *producing* nations to protect home industry. Webb-Pomerene Act associations and the Webb Act itself have nothing to do with fighting those barriers. Webb-Pomerene associations encourage those barriers because they naturally tend to respect them. Price-minded cartels are interested in keeping out foreign competition from the United States (because they are the major producers here). There is an understood rule of reciprocity at work, which stabilizes prices and protects home markets.

All of the facts should tell us, then, that we should have more competition, not less competition, if we want to increase our trade. Give us more aggressive marketing, not less. The facts establish, at very least, that Webb association export outlets are hardly worth the harmful effects on the domestic market. Those facts should also advise us: Be careful of these price-fixing and quota-setting organizations with their meetings, constant information-sharing and daily price-"predicting."

THE RESPONSES AND THE DANFORTH BILL

But our balance of payments is bad; and that means fewer jobs at home, a weaker dollar, a greater impetus to inflation and a thousand other ramifications that economists say we fall heir to. So the cartel believers come out of the woodwork and are listened to. Groups of them, particularly the National Construction Association, importune the Commerce Department. (They know enough to stay away from watchful Justice and sleeping FTC.) They go to the Congress. And, despite the empirical evidence that lies for the reading in FTC reports and records and despite a recent critical report of the President's special commission on the antitrust laws, we have the Commerce Department lobbying for more cartels and the lessening of restrictions on them. And we find some very able Senators believing in the benefits of more cartels and the lessening of restrictions on them. Logic and the facts are ignored; myths and plain fiction take over.

Indeed, Senator Danforth in conjunction with Senators Bentsen, Chafee, Javits and Mathias (a most formidable group) introduced a bill in the Senate last February that would amend the Webb-Pomerene Act by expanding its antitrust exemptions to allow for more restraints on domestic commerce, enlarging its coverage to activities beyond foreign export trade (as long as they were incidental to it) and placing services as well as goods under amended Webb Act protection. The bill would transfer supervision of the associations from the moribund Federal Trade Commission to the friendly Commerce Department and insulate the associations from direct Antitrust Division oversight. While there would be pre-registration screening for new Webb associations, all present associations would be grandfathered into the antitrust exemption, and no private person could sue to revoke or alter any association's status. A review of the new procedures under the Act would occur seven years from now.

The bill itself and Senator Danforth's Senate speech in support of it make it plain that it is the product of fear and fiction. The "findings" that appear in the bill as a preamble give the painful and scary fact of a $30 billion trade deficit in 1978, tell ominously of foreign government subsidized competition to United States exporters, note the fall of the United States' share of total world exports from 19 per cent in 1968 to 13 per cent in 1977 and then declare:

> "Small and medium-sized firms are prime beneficiaries of joint exporting, through pooling of technical expertise, help in achieving economies of scale, and assistance in competing effectively in foreign markets. . ."

That foreign government subsidized competition is not so terrifying and that small and medium-sized firms have never benefited from such joint exporting are now beside the point. Red has become green by proclamation and because of painful facts. The pre-judgers—the Department of Commerce—are the new guardians. The oligopolists and multi-nationals are to be rewarded by automatic inclusion in the new and more tolerant system. When one should hesitate, we legislate.

In his speech to the Senate introducing his bill, Senator Danforth acknowledges the poor performance of Webb associations as promoters of commerce and the fall-off in membership. But he gives some reasons. The first reason for Webb failure, he says, is that the "vast majority of the . . . Webb-Pomerene associations lacked sufficient product-market domination to exert foreign market price control and membership discipline." That, of course, is not changing facts; that is misreading their import. What Senator Danforth is telling us is that only the giants (1) have been able to use the Act and (2) have connived successfully to fix prices because they are dominant and can make their price-fixing stick. That hardly speaks for the need for more associations or the desirability of more leeway for *all* of them!

> "Senator Danforth's bill . . . is the most serious, recent and erroneous reaction to unfavorable foreign trade events. . . . The bill at best sets our sights away from where they should be. It is frightening that very sound men can be so misled."

Senator Danforth then tells us that the second reason for poor Webb-Pomerene performance is our "traditional" primary focus on the domestic market. Surely the primary focus of most of our indigenous industries will always be on our domestic market, the biggest market in the world; but the past two decades have witnessed an explosion of interest in foreign markets and a vast expansion in foreign trade. And look how Americans have jumped—tripped over themselves—at the opening of opportunities in China. Sufficient focus, there is; and foreign trade will expand. The facts bespeak a reason for failure other than a lack of focus on foreign trade: Interest in associating has not similarly expanded because the Webb Act can only benefit the dominant few in very special industries.

For his third reason for Webb-Pomerene failure, Senator Danforth offers the fact that services are not covered by the Webb Act. He then says that the President's National Commission for the Review of Antitrust Laws and Procedures recently recommended that services be covered. That is a gloss. The independent Commission appointed by the President made its report last January. There was a section on the Webb-Pomerene Act. The report reviewed the poor performance of Webb-Pomerene associations. It rejected the proposition that the Webb-Pomerene Act be expanded or even be kept in place. In fact, a number of Commissioners would have repealed it with no further ado. The report declared that automatic exemptions are not warranted, and a needs test should be required of all would-be registrants. The report urged that the Congress review the Webb-Pomerene Act with a view to repealing it or substantially restricting it. Its recommendation on services was that *if* the Act were retained then it saw no reason not to include services as well as goods.

Whatever, this catering to services is narrow special-interest legislation, a sop to the construction industry pressure groups. I predict that, if the special legislation ever comes to be, it will not spark any more activity abroad; it will only benefit the large corporations already in the market by a gift of immunized collusive price-setting—which will have the usual "predictive" price-setting influence in the domestic market.

For his fourth and "perhaps most important" reason why Webb-Pomerene has failed, Senator Danforth offers the hostile attitudes of the FTC and the Antitrust Division of the Justice Department and the fears that businessmen have that they will be declared antitrust violators if they join the associations. The fear of the FTC has to be a fiction; it has been a docile watchdog; more than docile, it has wagged its tail. It has gathered information from the associations without questioning the accuracy of anything and has done nothing with that information. It let one association rig bids for United States government AID-financed contracts for years; it was the Justice Department and eventually the Supreme Court that put a stop to that multi-million dollar raid on our Treasury.

As to the Justice Department, it has never made a wholesale attack on Webb associations, generally leaving them to the FTC. The Antitrust Division, however, can and does bring a welcome skepticism and questioning to bear on these cartels. Industry and the Congress should be grateful that someone is there ready to worry about whether permitted collusion has slipped into illegal conspiracy in domestic trade. Remember, under the Webb Act, people who are competitors and are not supposed to be setting prices for the domestic trade are in daily contact. They are constantly exchanging price, cost and supply information. They are continually agreeing to prices for future exports based on what they believe will be future market prices here and abroad. That's at least dangerous territory, if not (as most businessmen who have had experience with Webb associations believe) absolutely lethal ground for fair, competitive pricing.

Still the Antitrust Division has moved dramatically in all the Webb Act years only against the AID gougers. It has respected the Webb-Pomerene exemptions, even if many believe them to be unworkable. The only people who need fear (and, I submit, who have ever feared) the Antitrust Division are those who would *explicitly* (if covertly) use Webb Act functions as an occasion to agree to fix prices and set quotas in the domestic trade. Angels do not fear to tread where a haven is made for the unholy. It is not fear that has kept people away from Webb Act associations, but the fact that they don't find them helpful.

CONCLUSION

I have picked on Senator Danforth's bill because it is the most serious, recent and erroneous reaction to unfavorable foreign trade events. While it is hard to imagine that the Congress will pass the measure or the President would sign it (even though the Commerce Department cartel advocates speak to us as if they have the ear of the President), the bill at best sets our sights away from where they should be. It is frightening that very sound men can be so misled.

"Let us not for the sake of some minor hoped-for export trade advantage bring in certain major foreign trade and domestic market disadvantages."

Because the evidence is so overwhelming, I am emboldened to suggest what is needed. Let us reaffirm our belief in competition by private enterprise. Let's do away with the inherent unfairness of price-fixing; it is an instrument for oppressing all of us and fosters "greed" to our detriment. Let's speak no more about encouraging cartels. If anything, we should be looking to get rid of them. If there be any truth to the need for limited export associations, let the burden shift to those who would seek an exception to antitrust laws to prove they are not anticompetitive. Let us not for the sake of some minor hoped-for export trade advantage bring in certain major foreign trade and domestic market disadvantages. In any event, let us, first, undertake the study the President's Commission urged—before legislating. It makes no sense to put a truck in high gear and our foot on the pedal until we know whether the grade around the curve is steep.

Let us not be beguiled, misled or scared out of our common senses. ■

Mr. FINLEY. In many of these papers, I have described typical Webb-Pomerene associations and have shown that, contrary to the generally accepted concept, the expansion of the Webb-Pomerene Act's antitrust exemption will not stimulate an increase in our exports.

EXEMPTION DISCOURAGES COMPETITION

As we all know, this exemption was intended by Congress originally to enable small U.S. businesses to compete against the then prevailing European cartels. Contrary to this intent, this exemption has enabled, in fact, large U.S. companies to form cartels of their own, most often in areas where there is practically no foreign competition. Moreover, this exemption has discouraged, and not encouraged, competition and has led, and continues to lead, to further U.S. cartelization and control over the flow of U.S. exports. If exports are being restrained now, as they certainly are, they would be restrained even more if such bills were to pass. The most disturbing fact about all this is that the Webb-Pomerene associations benefiting from antitrust exemptions are composed mostly of members which, together, dominate also our domestic scene. Their immunized actions taken with respect to export pricing and setting quotas have a direct and adverse effect on the domestic market which they are able to influence simultaneously. Thus, our farmer, our worker, our tradesman, and, of course, our consumer, is forced to pay higher prices for the product.

The 1967 FTC study and hearings on the operation of Webb-Pomerene conducted by the U.S. Senate demonstrated how little that act and this antitrust exemption have done to encourage U.S. exports since 1916. To stimulate U.S. exports, we do not need the continuation and expansion of an act which encourages anticompetitive behavior.

We need, instead, to recognize that our failure to gain our appropriate share of the export market is due to this very anticompetitiveness which, in turn, contributes dramatically to our overall declining productivity, inflation, and much, much higher domestic prices of products.

The companies who need it the least benefit from the anticompetitive blessing of Webb-Pomerene and have produced hordes of witnesses to testify about the desirability of continuing that blessing. The general public who will be adversely affected cannot usually master the resources to make its voice heard.

Our export markets will expand with more—not less—competition. Companies such as ours can contribute to the give and take of the marketplace if they are allowed to.

As my National Journal article illustrates graphically, the Webb-Pomerene associations operate by excluding such companies as ours from the marketplace so that prices can be set for export and domestically production can be restricted.

The bill would also permit banks, bank holding companies, and international banking corporations to own export trading companies. The arguments for doing this point to the fact that bank organizations are able to reach out to a large number of small- and medium-size companies who may manufacture exportable products. My question is, Why don't these banks reach out to these companies now? Or for the past 25 years without this legislation? The other argument for the banks to participate is that their international branches and correspondents are in an excellent position to identify potential foreign markets and customers. Surely, they have been doing this for many decades and any exporter or manufacturer can get the banks to give them that information. Why is it, then, that they are asking for this legislation? My suspicion is that the power of the banks would be enhanced without corresponding contribution toward the expansion of exports, but with dramatic increase in the leverage which the banks would have to control and restrict exports to achieve their specific objectives and reducing the competition between the banks and making it even less likely for an independent exporter to be able to obtain suitable financing.

It is noteworthy that a number of commissioners of the National Commission for the Review of Antitrust Laws and Procedures favored outright repeal of the Webb-Pomerene Act. Their instinct was right. It is increased competition and increased productivity of capital labor that represent the foundations on which to build an expanding export trade. It is the essence of free trade and of America. We should all keep these points in mind when the decisions are made on the new export policy of our country.

Thank you.

The CHAIRMAN. Thank you very much. Professor Clark.

STATEMENT OF ROBERT C. CLARK, PROFESSOR OF LAW, HARVARD LAW SCHOOL

Professor CLARK. Thank you. My name is Robert C. Clark. I am a professor of law at Harvard Law School, where I teach courses in corporate law and the regulation of financial institutions. By financial institutions, I mean not only banks and other depository-type institutions like savings and loan associations, but also insurance companies, pension funds, and investment companies. I am not here to represent any trade association or organization of any kind. I have no consulting arrangements with any banks, but in the last few days I have been tempted to apply for a loan from the Bank of Libya. [Laughter.]

What I am here to do today is simply to comment upon one part of the bill, the provision which allows banking organizations to make equity investments in export trading companies. I support that idea. I have spent a lot of my academic career doing research on financial institutions, and specifically on two major problems. The first is the problem of soundness. Why should public policy be concerned with it? What are the different ways of achieving it? Which are best? Which are worst? I cited one of my works on that topic in the written testimony.

SEPARATION THEME

The second thing I worked on quite a bit is what I call the separation theme: The fact that not only banks but other kind of intermediaries like insurance companies in this country have been separated in various ways from other types of business activity. The connections between banking and insurance and other activities have been regulated. Of course, that is one of the ideas that came up in these hearings.

I would like to address the issue of whether this bill would constitute an unacceptable departure from this tradition. What I want to emphasize is that this separation idea is not a monolithic thing. It means a number of distinctly different things. There are somewhat different purposes to each part of the policy, and not all of them are applicable in this situation. Furthermore, not all of the kinds of separation regulation are traditional and of longstanding existence in this country. Some do not exist in other countries; some do.

I distinguish four kinds of separation regulation. I will briefly mention two, and say they are not infringed by the bill. One is the idea that a bank itself should not operate nonbanking activities. My research suggests the only real reason—the basic reason—for having that kind of policy has been to make it easier for bank regulators to achieve the objective of soundness, that is, to prevent the failure of banks from hurting depositors. There is no other serious objective one can find. I don't think the bill does anything to challenge that notion. A second kind of connection that has always been regulated is interlocks between bank managers and officers of unaffiliated businesses. The reasons behind that are sound antitrust policy. They are not affected by the bill.

The two things of interest are the other two kinds of separation regulation. First is regulation which structures and limits the terms, amount, and the kind of relationships and transactions between banks and their affiliates, by which I mean parent companies, sister companies, and such. That is on the one hand. On the other hand are limits on the nature of the business activity that bank affiliates can engage in. That is the only thing, that final kind of separation regulation, really challenged by this bill. It's not an enduring part of American history. It doesn't go back 100 years.

The first general prohibition on these kinds of affiliations occurred only in 1956, with the Bank Holding Company Act. That only applied to multibank holding companies. It was extended in 1970 to single-bank holding companies, on grounds which I argue were never entirely clear or persuasive and ought to be rethought. I would do away with the whole "closely related to banking" test—though not right away. I would like to do it in small steps. I think the proposed step is something which is such a thing, an experiment. We can see how it works out.

BALANCING TWO POLICY OBJECTIVES

I feel strongly about this, because it's important to balance two policy objectives in society: First, keeping bank deposits safe; second, efficiency. The proper attitude of Congress ought to be that it should not generally and routinely substitute congressional business judgment for that of businessmen. I think, therefore, that if private businesses want to go into a new venture and think that it will be feasible and profitable, they ought to be allowed to do so, unless there are clearly identifiable, empirically supported dangers that ought to be taken into account. And if that is the case, we ought to protect against those dangers in the least restrictive way, not by absolute prohibitions.

The reason I think the right way to control financial risks and other kinds of risks in the holding company system is by transac-

66-942 0 - 80 - 12

tional regulation, rather than by controlling the nature of affiliates' activities, is that, if you look at the history of bank failures, you will find the majority of them—and this is true of other financial institutions—occur because of some form of conflict of interest, self-dealing within the system, or managerial dishonesty.

There is a lot of that, and I would say those things should be controlled as such. I don't think that limits on the lines of business activity really respond to those dangers. They are beside the point.

This is explored more in the written testimony and in the article I would like to have included in the record, which I have given to the lady over there.

The final point I would make is about the control issue. It has been suggested that if the bill allows banks to get some sort of equity interest in export trading companies, that might be OK, but control is beyond the pale. I am simply baffled by this. I don't see the logical connection at all between control or the lack of it and the objectives behind restrictions.

The objectives seem to be to limit the bank's financial exposure and to preclude conflicts of interest. Forbidding bank control is a poor way to do either of those things. The bank could have a whole bunch of noncontrolling interests in export trading companies, up to 5 percent of its capital and surplus, and lose all of that. And if it had controlling interests, it could still only go to that limit, and that is what it could lose.

A suggestion was made awhile ago—and this is in some of the prepared testimony—that while other sorts of things may happen, the bank, if it controls an enterprise, may feel bound to help it out when it's in trouble. The answer to this problem is very simple. It is an answer that should have been pursued by the agencies in connection with the REIT experience: You can prohibit banks from getting involved in workout situations beyond what is permitted by certain guidelines. This bill allows for regulations and rules that would accomplish that.

An other suggestion that was just made was that sometimes the creditors of an export trading company will be able to get at the controlling bank's assets, even though its investment is legally limited. I suppose the idea is that they could do this by invoking legal doctrines like "equitable subordination," "piercing the corporate veil, "and the like. This argument comes up a lot in connection with discussions of the Bank Holding Company Act. It is an entirely speculative argument. It almost never happens. I know, because I read every single published case in the United States that dealt with the subject of corporate-veil piercing. You can find almost no cases—I do not remember any—in which bank depositors were subordinated to creditors of an affiliated enterprise. It is a minor risk. I think some of the other ones alleged are minor, too. As for the conflict-of-interest risk, which I tried to analyze in my paper, I do not see exactly how it would come about.

Rather than elaborate on that, I will, because of the time, simply stop.

[Complete statement follows:]

July 25, 1980

STATEMENT OF ROBERT C. CLARK, PROFESSOR OF LAW, HARVARD UNIVERSITY

My name is Robert C. Clark. I am a professor of law at the Harvard Law School, where I teach courses in corporate law and the regulation of financial institutions. (By financial institutions I mean not only banks and other depository-type institutions like savings and loan associations, but also insurance companies, pension funds, and investment companies.) I am not here to represent any trade association or organization of any kind. I have no consulting arrangements with any banks nor, for that matter, with any bank regulatory agencies. I am here only to speak for the public interest as I see it. Specifically, I would like to express my support for S.2718, the bill on export trading companies, and to comment upon §105, the provision that allows banking organizations to make equity investments in export trading companies.

Since I began my career in academic law six years ago, I devoted a great deal of my research and writing to certain problems affecting financial institutions that were impressed upon me by my prior experience in law practice. Because so much of the special, heavy regulation of financial institutions seemed directed to insuring the financial soundness of these institutions, and thus protecting their public creditors--in the case of banks, ordinary depositors--I decided to investigate the reasons for soundness regulation and the relative pros and cons of the different strategies for protecting the public creditors: limiting the institution's portfolio, controlling insider misconduct, creating deposit insurance schemes, and establishing anticompetitive price and entry controls like interest rate ceilings and restrictions on bank branching. The result was a major law review article. (The Soundness of Financial Intermediaries, 86 Yale L.J. 1 (1976)). A second major topic was what I call the separation theme-- the fact that American law, in a fascinating variety of ways, tries to keep financial-institution activities like banking and insurance separate from other business activities. This work led to another law review article (The Regulation of Financial Holding Companies, 92 Harv. L. Rev. 787 (1979)), which is so germane to the concerns raised by the export trading company bill that I would like to have it included in the record of these hearings. (A copy of it is included with this statement.)

In my remarks today, I want to address one single issue: the possibility that Section 105 of the export trading company bill runs afoul of the traditional principle of separating banking from commerce. This is a legitimate concern, perhaps the most important one about the bill, but the question cannot be answered by vague appeals to a mystical 100-year tradition or a "long established principle" that has supposedly "served our country well". One must first get some clear ideas about the operational meaning of separation policy, the reasons for it, and the guidelines lawmakers ought to follow in carrying the policy out. Let me elaborate.

There are at least four ways in which legal regulation can and does "separate" banking from other business activities or, more accurately, regulates the connections between banking and other businesses. (1) The bank itself, as a legal entity, can be forbidden to operate nonbanking or nonfinancial activites, as opposed to making loans and investments in securities. This is the oldest form of separation regulation, and the most necessary and defensible. The purpose of it, in my view, is the straightforward one of <u>facilitating</u>, or making easier, the regulators' attempts to keep banks sound: it does this by making the things to be regulated simple rather than complex. The proposed bill is <u>not</u> a departure from this traditional principle, since banks themselves will not be allowed to operate export trading businesses as divisions of the banks.

(2) A bank may be restricted in the kind, quantity, and terms of its relationships and transactions with nonbanking affiliates, that is, with parent, subsidiary or sister companies. The purpose of these restrictions, which also go far back in history, is again to preserve bank soundness: they do this by trying to prevent conflicts of interest and transactions within a holding company system that are unfair to the bank. The top management in a bank holding company may have, for a number of reasons, personal incentives to bias transactions within the system against the bank and in favor of other companies. The controls on relationships and transactions within the system are an absolutely crucial kind of

regulation, in my view, because an examination of the history of bank and insurance company failures shows that by far the major reason for these failures is some form of managerial dishonesty. The problem has not been so much excessive but honest risk taking or simple business blunders, but fraud, self-dealing, and conflicts of interest. In my view, the proposed bill does not conflict with this traditional form of separation regulation either, for it imposes an adequate battery of controls on relationships between banking organizations and their related export trading companies.

(3) The third kind of separation regulation consists of restrictions on the kinds of business activities that affiliates of banks may legally carry on. The Bank Holding Company Act, for example, limits bank affiliates to activities "closely related" to banking. In historical terms, this kind of separation regulation is a relative Johnny-come-lately. Though the Glass-Steagall Banking Act of 1933 prohibited bank affiliations with securities firms, it was not until the Bank Holding Company Act of 1956 and its 1970 Amendments that first multiple and then single bank holding companies were subjected to a general prohibition against affiliation through stock ownership with nonbanking companies. In comparative terms, this kind of regulation is also less extensive than the other two kinds. For example, within our own legal system the insurance holding company laws that virtually all states have do not impose activity restraints on insurance company

affiliates--though state laws do severely restrict insurance company activities and transactions with affiliates--and the federal Savings and Loan Holding Company Act only imposes them on multiple savings and loan holding companies. Moreover, a number of other major industrialized countries regulate banks heavily, but do not restrict the activities of bank affiliates nearly as severely as American law does. The purposes of limiting the nature of bank affiliates' business activities have never been entirely clear or persuasive. One major argument in the bank holding company context has been the fear that allowing financial conglomerates to exist would lead to an increased risk of anticompetitive practices, such as tie-ins between bank loans and sales of products offered by the affiliates. In retrospect, as I show in my article on the separation theme, these fears seem to have been greatly exaggerated. In any event, no one seems to be raising serious objections to the export trading company bill on these grounds.

A second major argument for activity limits on bank affiliates has been that the inevitable involvement of the banks in their affiliates' fortunes--by way of loans or advisory contracts, for example--means that regulators, since they aim to protect bank depositors, have a proper concern about controlling the financial exposure created for banks by these involvements, and that a strong way of doing this, although it is a crude and blunt way, is simply to prohibit affiliation by stock ownership with most other businesses. Though many proponents of this view do not seem to recognize the point, this argument must be based on the assumptions that transactional controls between banks and nonbanking affiliates do not work well and cannot be made to work well by any amount of legislative and regulatory reform. My view is that these assumptions are wholly gratuitous and wrong; they cannot be supported by the systematic empirical studies that so many economists, both in and out of the bank regulatory agencies, have carried out on the characteristics and behavior of bank holding companies, or by a close reading of history. My inclination is therefore to be very skeptical about the validity of the celebrated "closely related to banking" test in Section 4(c)(8) of the Bank Holding Company Act. I do not believe that the test serves any identifiable, legitimate public purpose that is not better served (or could not be better served) by other, less restrictive regulation. Consequently, I find it irrational to object to Section 105 of the export trading company bill <u>simply</u> on the ground that under it some banks would have affiliates that engage in a form of commerce. What really ought to be the focus of concern is whether the bill provides adequate safeguards to insure the soundness of banks, by (a) limiting their financial exposure and (b) regulating their relationships and transactions in a way that will minimize the risk that unfair self-dealing will occur and will hurt the banks involved.

The bill contains a number of different kinds of controls on banks' financial exposure and the risk of harmful self-dealing transactions with export trading companies: there are mechanical, structural rules within the statute itself that are aimed at prevention; there is provision for regulatory controls; and there are special statutory rules dealing with particular kinds of risks that are envisioned with respect to export trading companies. Under the first heading I would put the rule that limits equity investments in an export trading company to 5% of a banking organization's consolidated capital and surplus, and the rule that limits investments together with loans and other extensions of credit to 10% of capital and surplus. I would also point out that other provisions of banking law, already in existence, restrict the total amount of a bank's loans to and investments in all of its affiliates to 20% of the bank's capital and surplus. Under the second heading I would place the provision requiring bank regulatory approval for larger acquisitions and controling acquisitions of export trading companies, the extremely open-ended, useful power given to the agencies to condition approvals in ways needed to reduce financial exposure and the risk of conflicts of interest, and the provision giving regulatory agencies the power to terminate a bank's relationship with an export trading company. Under the third heading, I would place the rules against name similarity, speculation in commodities, and the making by the banks of abnormally risky loans.

(4) I will mention the fourth kind of separation regulation for the sake of completeness. Various legal provisions restrict managerial overlaps, e.g., interlocking directorates, between banks and various unaffiliated enterprises. Their purpose is to assist antitrust policy by reducing occasions for managers to engage in collusion. The proposed bill in no way contravenes this regulatory tradition.

Thus, the main focus of the Committee, in assessing whether the bill unduly departs from the complex cluster of past policies regulating connections between banking and commerce,ought to be whether the goals of the second kind of separation regulation, which deals with the terms of relationships and transactions between banks and their affiliates, are adequately met. In this light, two concerns about the bill appear to me to be misplaced. The first is the notion that bank ownership of noncontrolling stock interests in export trading companies may be tolerable, but controlling interests are beyond the pale. I am baffled by this distinction, for I do not see a clear connection between it and the likely degree of risk to bank soundness. Whether a bank buys several minority blocks of stock in different trading companies or a smaller number of controlling blocks has little to do with permissible extent of the bank's financial exposure: the 5% and 10% tests take care of that problem. And whether a bank's officers can directly or indirectly control the business decisions of an export trading company has a bearing on self-dealing risks, but it is not what one might casually think. The positive significance of control is that if the bank has it, and banks really are able to generate synergistic gains by lending their know-how to trading companies, the bank is more certain of implementing its business decisions and reaping the benefits thereof; it is also less likely to be abused by those in charge of the company, as minority shareholders often are. These possibilities clearly speak in favor of allowing bank control.

The negative side of control is that the bank which controls an export trading company can make it enter a transaction that hurts the export trading company and its minority shareholders, but helps the bank, and therefore actually increases bank soundness and the protection of depositors. An example is a loan to the trading company at an excessive interest rate. This might occur, but it is the kind of possibility that afflicts all minority shareholders in all corporate subsidiaries. It is controlled by corporate law doctrines, and any reforms ought to be made by changing corporate laws, not the banking laws. Of course, one may reply that the bank controlling an export trading company might make loans to it at an unfairly low interest rate, and this would cheat the bank if the bank owned less than 100% of the trading company stock. This is abstractly possible, but I cannot imagine that any <u>rational</u> officer of the bank or bank holding company, whose own compensation is tied to performance of the banks or the holding company, would want to do it, even if he were looking out solely for his own interest.

The second misplaced concern that might be voiced about the bill is that the claimed synergistic gains from letting banks own export trading companies have not been conclusively proven. My view is that this attitude turns the proper burden of proof backwards. When private businesses contemplate trying new ventures, their own self interest will lead them to make the most rational judgments they can about feasibility and profitability, so lawmakers ought to adopt the presumption that they should be allowed to try new ventures <u>unless</u> there are compelling, clearly identifiable, empirically supported reasons for enacting prohibitions or restrictions. Congress should not be in the habit of routinely substituting its own business judgment for that of businessmen. Furthermore, enacted legal restraints should always be the least restrictive ones that will achieve the legislative goals. Only then will the law permit maximum efficiency and productivity--which are desperately needed in this country at the present time. Following this philosophy will lead one, I think, to support S.2718.

THE REGULATION OF FINANCIAL HOLDING COMPANIES

Robert Charles Clark

TABLE OF CONTENTS

VOLUME 92 FEBRUARY 1979 NUMBER 4

HARVARD LAW REVIEW

THE REGULATION OF FINANCIAL HOLDING COMPANIES

Robert Charles Clark *

A common trait of laws regulating financial intermediaries and their holding companies is the attempt to separate intermediation from other business activities. In this Article, Professor Clark describes the pervasiveness of this trait and, after an analysis of the possible justifications for it, determines that separation regulation is primarily addressed to antitrust concerns and to the concern for facilitating regulation of the soundness of financial intermediaries. He argues that the first concern does not call for specialized antitrust legislation whereas the second demands that current regulation be strengthened significantly.

IN the United States, the regulation of banks, insurance companies, and savings and loan associations, as well as their various holding companies,[1] exhibits a persistent common theme that is both theoretically fascinating and of the utmost practical consequence. Stated generally, the theme is as follows: regulation sharply limits the ways in which financial-intermediary activities proper, that is, banking and insurance,[2] may be connected to

* Professor of Law, Harvard University.

[1] The list is narrower than what would be captured by the phrase, "financial intermediaries and their holding companies." As I use the term, "financial intermediaries" includes depository institutions, such as commercial banks, savings and loan associations, mutual savings banks, and credit unions; insuring institutions, such as life insurance companies, property and liability insurance companies, and pension plans; and investment companies, such as mutual funds, closed-end funds, and real estate investment trusts. For simplicity, and because the relevant law adds little to the themes explored here, mutual savings banks, credit unions, and property and liability insurance companies are virtually ignored in this Article. As for investment companies, they rarely belong to holding company systems in the sense of groups of companies affiliated through stock ownership. Nevertheless, they frequently do belong to a looser system of entities that are under the de facto control of common managers; the significance of these arrangements is explored pp. 832–33, 844–45 *infra*.

[2] The term "financial-intermediary activities" actually includes not only banking and insurance but also investment pooling on behalf of small investors, such as is provided by investment companies. Indeed, investment companies are the purest and simplest types of financial intermediaries, for most of the other financial intermediaries, which do in fact pool investments on behalf of their public suppliers of capital, also provide substantial noninvestment services, such as provision of a means of payment (*e.g.*, checking accounts) or insurance protection

other activities. For brevity, I will refer to this as the separation theme, since the laws in question strive, in various ways and with varying intensity, to keep financial intermediation isolated from other activities. The purpose of this Article is to explore the existence, justifications, and ramifications of the separation theme.

It is important, at the outset, to focus on the basic elements of the separation theme, for much previous literature has focused on technical fractions of the problem, with little evident awareness of a larger and simpler pattern. My general formulation of the theme leads naturally to several questions. First, what are "banking" and "insurance"? That is, what are the proper definitions of the intermediary activities that the law tries in so many ways to keep separate from nonintermediary activities? Second, what are the different kinds of "connections" between intermediation and other activities that the law could, does, and should prohibit or regulate? Some connections that are subject to regulation are the operation of an intermediary business and a nonintermediary business within the same corporate entity, the affiliation [3] through stock ownership of a corporation engaged in banking or insurance with a corporation engaged in other activities, the execution of transactions between banks or insurance companies and their affiliated corporations, and the existence of overlapping directors or officers of an intermediary and a nonintermediary company. Third, does and should separation regulation vary depending on which precise kinds of nonintermediary activities are involved, and if so, how? Four categories of activities may usefully be distinguished. The first is nonfinancial activities. At the opposite end of the spectrum are other intermediary activities. May the two major categories of intermediation, banking and insurance, be combined or connected? Between these poles are the two categories that historically have caused the greatest difficulty, investment banking and investment management.

These three sets of questions are examined throughout this Article. Part I shows how a multitude of apparently diverse legal rules relate to the separation theme. Part II considers what

---

against noninvestment risks, that are viewed by the public as the primary reward for furnishing money to the intermediary. But, as mentioned in note 1 *supra*, investment companies will not be given separate treatment, though the permissible relationships between banks and investment companies and between insurers and investment companies are explored at various places. *See* pp. 798–800, 808–10 *infra*.

[3] An "affiliate" of a corporation is a person that controls, is controlled by, or is under common control with, the corporation. The term "person" includes corporations and natural persons, as well as partnerships, most trusts, and organized groups of natural persons.

major, legitimate public policies may justify separation regulation, and Part III evaluates the major features of the existing regulatory patterns in light of those policies. While questions about the meaning of "connections" and "other activities" in my general formulation of the separation theme are dealt with in the first three parts, Part IV takes up for special consideration the proper limits of the terms "banking" and "insurance." This subject, which merits separate treatment because of the legal controversy to which it has given rise, is best discussed only after a resolution of basic policy issues.

Obviously, one can neither find coherence or intelligibility in the existing law's answers to the questions I have put, nor evaluate the answers, without a grasp of the policies behind the separation theme. Because my argument is somewhat involved, it may be helpful to present an overview of it here. Out of a host of seemingly plausible policy candidates, I will identify two significant contenders. One is the goal of facilitating regulation to insure the soundness of financial intermediaries.[4] Separation techniques may aid soundness regulation by making it administratively simpler and more efficient, and they may prevent its subversion by excessive fraud and abusive conflicts of interest. The other goal of separation regulation might be loosely described as consisting of antitrust policies. Roughly speaking, my conclusions are that the first goal requires regulation that is stricter in some respects than existing law, that the second goal should be handled by general antitrust regulatory techniques and does not justify very much special legislation directed at financial holding companies, and that important features of existing law serve no legitimate public purpose and should be abolished. The principal legal pattern in this latter category is the limitation of holding company affilities of intermediaries to lines of business that are, depending on the context, "closely related" to banking,[5] "reasonably ancillary" to insurance,[6] or a "proper incident" to the savings and loan business.[7]

I. LAW: THE EXISTING PATTERNS AND THEIR RELATIONSHIPS

This Part will focus on the extent to which current law regulates acquisitions of intermediaries, nonintermediary activities of

[4] On the meaning of soundness, the reasons for making it a legislative goal, and the merits of various strategies for achieving it, see Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1 (1976).

[5] *See* pp. 796–98 *infra*.

[6] *See* pp. 807–09 *infra*.

[7] *See* pp. 812–13 *infra*.

intermediaries, nonintermediary activities of affilates, transactions among affiliates, and managerial overlaps. It is of interest, in view of the heightened corporate takeover activity that is now occurring, to note that, in the case of each of the three types of financial holding companies examined here, the significant laws concerning affiliates were enacted in the late 1960's, a period of numerous conglomerate acquisitions.

A. Bank Holding Companies

1. Acquisitions of Banks. — Before examining the activity restrictions on bank holding company systems,[8] it is helpful to understand some basic elements of the regulation of multibank holding company systems, even those attempting no nonbanking activities. The rules governing formations and acquisitions by such systems of additional banks display themes that will serve as a benchmark for considering the tests applied to formations and acquisitions of nonbanks.

The growth and importance of multibank holding companies have led to federal regulation, even where the companies control only banks that are neither federally chartered nor members of the Federal Reserve System. Section 3 of the Bank Holding Company Act[9] governs bank holding company acquisitions of any type of bank. It requires the prior approval of the Board of Governors of the Federal Reserve System before certain types of acquisitions and similar activities.[10] The statute sets out the procedures for seeking approval, the most important aspect of which is that any order by the Board granting an application does not

---

[8] In this Article, I will usually distinguish among banks, bank holding companies (in the sense of corporate entities that control banks), bank affiliates (in the sense of companies, including bank holding companies, that are affiliated with banks through stock ownership or other control devices), and bank holding company systems (meaning a bank and all of its affiliates including nonbank affiliates). A similar usage will be followed in the Sections dealing with insurance. It should be noted, however, that in the literature the phrase "bank holding company" may be used in three different ways: to mean the holding company proper, to mean the holding company and its nonbank affiliates, or to mean the holding company and all of its affiliates. The context usually makes clear which meaning is intended, but only if one already has some knowledge of the holding company statute.

[9] 12 U.S.C. § 1842(a) (1976). The subsection requires approval before any of the following: (1) any company becomes a bank holding company (BHC), (2) any bank becomes a subsidiary of a BHC, (3) any BHC acquires direct or indirect ownership or control of the bank stock if the acquisition will increase the BHC's interest in that bank to more than five percent of the voting shares, (4) any BHC or nonbank subsidiary of a BHC acquires substantially all of the assets of a bank, or (5) any BHC merges or consolidates with any other BHC.

[10] *Id.* §§ 1842(b), 1849(b); *see* regulation Y, 12 C.F.R. §§ 225.3, 265.2 (1978).

become final until thirty days after issuance so that the Justice Department may challenge the application on antitrust grounds. Subsection 3(c) sets out the substantive criteria for approval of bank acquisitions.[11] The first paragraph of the subsection directs the Board not to approve an acquisition which would result in a monopoly or further a combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States; it apes section 2 of the Sherman Act.[12] The second paragraph follows Clayton Act section 7 [13] by proscribing any acquisition whose effect may be substantially to lessen competition, but adds a proviso not found in the Clayton Act: "unless it [the Board] finds that the *anticompetitive effects* of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the *convenience and needs* of the community to be served." [14] The third criterion is in a final sentence which says that in every case the Board shall consider the *financial and managerial resources* and future prospects of the company or companies and the banks concerned, and the convenience and needs of the community to be served.[15] It seems established that the Board has no authority under section 3(c) of the Bank Holding Company Act to consider factors, such as fairness of the acquisition price paid to minority shareholders of a target bank, other than the three principal ones indicated in the statute.[16] The provisions of section 1 of the Bank Merger

---

[11] 12 U.S.C. § 1842(c) (1976).

[12] 15 *id.* § 2.

[13] *Id.* § 18.

[14] 12 *id.* § 1842(c)(2) (emphasis added).

[15] *Id.* § 1842(c).

[16] *See* Western Bancshares, Inc. v. Board of Governors of the Fed. Reserve Sys., 480 F.2d 749 (10th Cir. 1973).

In addition to satisfying the federal law, bank holding companies seeking additional banks must not be caught by any of three types of state restrictions — branching laws, bank holding company laws, and failures to permit entry by out-of-state holding companies. National banks are bound by state branching laws, 12 U.S.C. § 36(c) (1976). A BHC trying to establish or acquire another bank, whether state or federal, may be attacked on the ground that the new bank would be a de facto branch of an existing subsidiary bank of the BHC, and as such would violate a state restriction on branching. *See, e.g.*, First Nat'l Bank v. First Bank Stock Corp., 306 F.2d 937 (9th Cir. 1962). Bank Holding Company Act § 7, 12 U.S.C. § 1846 (1976), preserves state jurisdiction over BHC's. Many states have bank holding company laws, some of which flatly prohibit BHC's.

In addition, Bank Holding Company Act § 3(d), 12 U.S.C. § 1842(d) (1976), prohibits an out-of-state BHC from acquiring an in-state bank unless the acquisition is "*specifically* authorized by the *statute* laws of the State . . . by language to that effect and not merely by implication" (emphasis added). Most states have no relevant laws.

Act of 1966 [17] are very similar, and to some extent regulators and judges have used similar language to elaborate the meaning of the three principal elements of the substantive rule in both laws.[18]

The "anticompetitive effects" test for bank mergers and acquisitions shows clearly a congressional determination that antitrust concerns about business combinations are not called off simply because the combining entities are banks, which already are subject to intensive special regulation. Why it was thought desirable to go beyond simple clarification of the applicability of the Sherman and Clayton Acts to banks is much less clear. The "convenience and needs" defense obviously was intended to dilute the antitrust standards applied to banks. The fact that the test looks to the convenience and needs of a community — depositors and borrowers, essentially — might suggest that Congress thought that facilitating the satisfaction of communities' desires for banking services is so much more important than facilitating the satisfaction of their desires for all other business services that a weakening of normal antitrust policy was warranted. But this notion is somewhat misleading. It is more instructive to locate the "convenience and needs" concept within a broader perspective. For many years the need criterion, phrased variously as "convenience and needs," "convenience and advantage," or the like, has been applied as a test for prior regulatory approval of key events in the business of banking, such as obtaining a charter [19] and open-

[17] 12 U.S.C. § 1828(c)(5) (1976).

[18] A good case exemplifying the Board's approach to subsection 3(c) of the Bank Holding Company Act is First Florida Bankcorporation, 59 Fed. Res. Bull. 183 (1973). In the spirit of more recent Supreme Court opinions, *e.g.*, United States v. Marine Bancorporation, 418 U.S. 602 (1974), the Board rejected a potential-competition argument against the proposed merger of two large BHC's.

For "convenience and needs" as a defense under the Bank Merger Act, 12 U.S.C. § 1828(c)(5) (1976), see United States v. Third Nat'l Bank, 390 U.S. 171, 186 (1968) (convenience and needs defense could apply where merged institution has "capabilities for serving the public interest not possessed by either of the two merging institutions alone," *e.g.*, where a near-insolvent bank is rescued) (dictum); United States v. First City Nat'l Bank, 386 U.S. 361 (1967) (convenience and needs defense must be pleaded and proved by defenders of the merger).

The "financial and managerial resources" test is the basis for the Board's view that a high level of acquisition debt may keep a BHC from helping subsidiary banks in trouble and may tempt it to milk its banks in order to repay the debt. *See* R. POZEN, FINANCIAL INSTITUTIONS: INVESTMENT MANAGEMENT 467 (1978). The Board has general rules about the proper capital structure for BHC's that acquire banks or other BHC's; 12 C.F.R. § 265.2(f) (1978), but neither these rules nor the decisions give precise criteria for the capital structure of a BHC system. Recently, the Supreme Court did uphold the Board's power to deny an application on the ground that the proposed BHC would not be a source of financial and managerial strength to its subsidiary bank. *See* Board of Governors of the Fed. Reserve Sys. v. First Lincolnwood Corp., 99 S. Ct. 505 (1978).

[19] *E.g.*, N.Y. BANKING LAW § 24 (McKinney 1971).

ing a new branch.[20] The same has been true in the operation of other financial intermediaries.[21]

A traditional part of the reasoning behind the use of the need criterion has been that restriction of entry is necessary to promote the goal of ensuring the financial soundness of intermediaries; preventing "overbanking" will reduce its supposed corollary, a socially excessive risk of bank failures, or failures of other intermediaries. In the acquisition context, denying approval of a proposed combination conceivably might promote the soundness of banks competing with one or more of the combining banks. But this consideration would point in the same direction as any possible anticompetitive effects of the acquisition, rather than outweighing them. In a few cases, a combination might promote the soundness of one of the banks involved, especially if it were a "failing company." In this situation general antitrust principles already grant a defense;[22] the "convenience and needs" language in section 3 of the Bank Holding Company Act can therefore be read as a signal to treat this defense in a generous way.[23] The final test in the section 3 trilogy, "the financial and managerial resources" of the combining companies, is one that is obviously directed towards bank soundness.

In summary, then, the federal law's substantive tests for bank mergers and holding company acquisitions of banks display a dual objective, the furtherance of general antitrust policies and the promotion of bank soundness, and the importance of the second goal seems to have been thought to require some sacrifice in the degree to which the first is obtained.

2. *Nonbanking Activities of Banks.* — The law's approach to the permissible activities of banks is nicely reflected in a striking contrast between the draftsmanship of the special laws under which banks are incorporated and the general laws under which most business corporations are chartered. The powers-and-purposes provisions of the former are expressed in an essentially closed list; those of the latter, in more open-ended concepts. For instance, the basic provision governing powers of national banks simply grants elementary corporate powers and lists the many banking functions — most of them quite traditional — that na-

---

20 *E.g.*, *id.*, §§ 29, 105 (McKinney 1971 & Supp. 1978).

21 *See* Clark, *supra* note 4, at 30 n.87.

22 *See* 3 P. AREEDA & D. TURNER, ANTITRUST LAW ¶ 701h, at 106–08 (1978); 16B J. VON KALINOWSKI, BUSINESS ORGANIZATION: ANTITRUST LAWS AND TRADE REGULATION § 19.03, at 19–131 to -144 (1978).

23 *See* United States v. Third Nat'l Bank, 390 U.S. 171, 187 (1968) (applying this interpretation to the identical provision of Bank Merger Act of 1966, § 1, 12 U.S.C. § 1828 (1976)).

tional banks are allowed to perform.[24] If an act is not described in the list, the bank cannot do it. In addition, other provisions of the federal banking laws explicitly deny or restrict the powers of national banks in various ways.[25] By contrast, the Delaware Corporation Law states that corporations may be organized under it "to conduct or promote any lawful business or purposes," [26] except as otherwise provided by the Delaware Constitution or other laws, *e.g.*, the provision denying banking powers to companies incorporated under the general law.[27] To be sure, banks are often given leeway by state laws to engage in a small amount of nonbanking activity,[28] and the federal law grants national banks incidental powers necessary to carry on the business of banking,[29] but this is a far cry from the open-endedness of the business corporation laws. History has occasionally dramatized the difference, as when the innovative interpretations by Comptroller James Saxon in the 1960's of the National Banking Act's incidental powers clause were frequently overturned in the courts.[30]

3. Nonbanking Activities of Bank Holding Companies. — Section 4(a) of the federal Bank Holding Company Act,[31] which governs all bank holding companies, generally prohibits bank holding companies from acquiring shares in nonbanking companies. Section 4(c) sets forth numerous exemptions. By far the most important and controversial is given by section 4(c)(8).[32] Briefly stated, it exempts transactions that satisfy two tests: the nonbanking activity that the bank holding company proposes to

[24] 12 U.S.C. § 24 (1976).

[25] *See, e.g., id.* § 24, para. 7 (national banks may not act as underwriters or dealers in corporate stock for their customers, generally may not own common stock for their own accounts, and may purchase "investment securities," *i.e.*, debt instruments, only as prescribed by the Comptroller of the Currency); *id.* § 29 (national banks generally may not own real estate other than their own office buildings); *id.* § 92a (trustee and other fiduciary powers limited to those available to state banks in the same state).

[26] DEL. CODE ANN. tit. 8, § 101(b) (1974).

[27] *Id.* tit. 8, § 126. Of course, a corporation could not stand ready to engage in almost any business activity unless its certificate of incorporation contained an open-ended purposes clause, but Delaware law clearly permits such clauses.

[28] *E.g.*, MASS. GEN. LAWS ANN. ch. 172, § 48, para. 20 (West 1972) (banking departments of trust companies permitted to invest up to three percent of deposits in otherwise ineligible investments).

[29] 12 U.S.C. § 24, para. 7 (1976).

[30] *See* Arnold Tours, Inc. v. Camp, 472 F.2d 427 (1st Cir. 1972) (striking down a regulation permitting banks to operate travel agencies); Port of New York Auth. v. Baker, Watts & Co., 392 F.2d 497 (D.C. Cir. 1968) (striking down a Comptroller regulation permitting national banks to underwrite revenue bonds).

[31] 12 U.S.C. § 1843(a) (1976).

[32] *Id.* § 1843(c)(8).

start or acquire must be "closely related" to banking, and it must produce "public benefits." The latter requirement entails a balancing of at least three types of possible benefits — greater convenience, increased competition, and efficiency gains — and five types of possible adverse effects — undue concentration, decreased competition, unfair competition, conflicts of interest, and unsound banking practices.[33] Though its language differs from the test for bank acquisitions in section 3 of the Bank Holding Company Act, the public benefits test can be seen to contain the same dual objective of furthering antitrust policies and promoting bank soundness. For instance, conflicts of interest were thought important precisely because they threaten bank safety, and not because they threaten to injure bank stockholders.[34]

The "closely related" test has been spelled out, to a large extent, in the Federal Reserve Board's regulation Y,[35] although some important determinations have been made in the course of decisions on specific applications. Interestingly, the activities listed by regulation Y as closely related to banking are rather traditional; most are legal for national banks to engage in directly. One may group them into four categories: credit extensions and related activities, financial management, data processing services related to banking and finance, and specialized courier services.[36]

---

[33] *Id.*

[34] As to the conflict of interest created by interaffiliate loans, for example, consider the following:

> The reasons underlying the divestment requirement [of H.R. 6227, a compromised version of which became the Bank Holding Company Act of 1956] are simple. As a general rule, banks are prohibited from engaging in any other type of enterprise than banking itself. This is because of *the danger to the depositors* which might result where the bank finds itself in effect both the borrower and the lender. . . . [I]n critical times the holding company which operates nonbanking businesses may be subjected to strong temptation to cause the banks which it controls to make loans to its nonbanking affiliates even though such loans may not at that time be entirely justified in the light of current banking standards.

H.R. REP. No. 609, 84th Cong., 1st Sess. 16 (1955) (emphasis added).

[35] 12 C.F.R. § 225.4(a) (1978).

[36] *See* Schotland, *Bank Holding Companies and Public Policy Today*, in HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, 94TH CONG., 2D SESS., FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY (FINE), COMPENDIUM OF PAPERS PREPARED FOR THE FINE STUDY 233, 239–40 (Comm. Print 1976). The 12 activities in regulation Y are grouped and categorized as follows:

> a. *Credit extension* and related activities: lending such as is done by mortgage, finance, or factoring companies; lending by industrial banks or loan companies; servicing loans; leasing that is equivalent to financing the lessee; investing in projects designed to promote community welfare; acting as insurance agent or broker where the insurance is directly related to credit or financial services; and underwriting credit life and credit accident and health insurance directly related to extensions of credit.
>
> b. *Financial management*: management consulting for unaffiliated banks;

Just as significant are activities that the Board has found to be impermissible: operation of a savings and loan association, underwriting life insurance not sold in connection with credit extensions by some member of the bank holding company system, equity funding (the combined sale of mutual fund shares and insurance), real estate brokerage, land development, real estate syndication, property management, and management consulting except to unaffiliated banks.[37]

Between 1970 and 1976, about seventy percent of the de novo entries had been into only four fields: consumer finance, mortgage banking, insurance, and financial leasing.[38] Of these, only insurance raises doubts about the closeness of its relationship to banking. It is not surprising that independent insurance agents were quick to challenge the regulation in court. In the important recent case of *Alabama Association of Insurance Agents v. Board of Governors of the Federal Reserve System*,[39] the Fifth Circuit took the opportunity to lay down some parameters of permissible insurance activities by bank holding companies. Although some parts of the Board's regulation were struck down, the court upheld a provision of great practical importance permitting holding company affiliates to act as insurance agents or brokers for the sale of property or liability insurance in connection with the affiliated bank's extensions of credit to its customers for the purpose of buying the insured property. Thus, when a bank makes a home mortgage loan or a car loan, the affiliated company can sell the borrower his homeowners' or automobile insurance policy.

The area of permissible connections between banking and the business of providing investment banking services or investment management to others has been a source of continuing controversy. Five bank activities should be noted: operating a disguised investment company, dealing with explicit investment companies, managing pension funds, creating entities that look like investment companies specializing in holding mortgages, and sponsoring other investment services.

Consider Citibank's effort, some years ago, to get into the

---

performing fiduciary activities; and acting as investment or financial adviser to mortgage or real estate investment trusts, to investment companies (under certain quite restrictive conditions), or to state and local governments.

c. Providing *data processing* services related to banking and finance.

d. Providing specialized *courier services*.

For a comprehensive review, see P. HELLER, HANDBOOK OF FEDERAL BANK HOLDING COMPANY LAW 229–61 (1976).

[37] 12 C.F.R. § 225.126 (1978).

[38] Schotland, *supra* note 36, at 241–43.

[39] 533 F.2d 224 (5th Cir. 1976), *vacated in part*, 558 F.2d 729 (5th Cir. 1977), *cert. denied*, 435 U.S. 904 (1978).

booming mutual fund business by operating a "commingled managing agency account," which appeared to most observers to differ in few essentials from a mutual fund. In *Investment Company Institute v. Camp*,[40] the Supreme Court held the Comptroller's regulation that authorized sale of interests in such a fund invalid, as a violation of the Glass-Steagall Banking Act of 1933.[41] The Glass-Steagall Act generally mandates the separation of commercial banking from investment banking. Section 16 of the Act[42] forbids national banks to underwrite any issue of securities or stock and limits their dealing in securities and stock to purchases and sales solely upon the order and for the account of customers. Section 21[43] prohibits firms engaged in the business of underwriting, selling, or distributing securities, at wholesale or retail — that is, securities firms — from engaging in the business of deposit banking. The Court's condemnation of the commingled fund arrangement in *Camp* was crucially related to the bank's proposed method of marketing interests in the fund. Banks had long been permitted to give individual customers investment advice and to execute trades for them, and had been allowed to operate common trust funds in which individual fiduciary accounts could be commingled.[44] The Citibank arrangement could have been seen as a mere inoffensive combination of activities that were quite similar to activities that were separately permitted to banks.[45] The crucial difference, however, is that the new arrangement would have involved the bank in the aggressive promotional efforts that characterize securities firms' activities and that were thought by Congress to implicate banks in various conflicts of interest and to tempt them to engage in unsound practices.[46]

Suppose that Citibank had established its commingled fund as a separate legal entity, that is, as an explicit investment company, had restricted itself to giving investment advice to the entity, and had caused a nonbank affiliate of itself to underwrite and distribute interests in the fund. It would have seemed to fall outside sections 16 and 21 of the Glass-Steagall Act. True, the fund would then be seen, rather clearly, to be an investment company subject to the Securities Act of 1933[47] and the Investment Company Act

---

[40] 401 U.S. 617 (1971).

[41] Ch. 89, 48 Stat. 162 (1933) (codified in scattered sections of 12, 15, 30 U.S.C.).

[42] 12 U.S.C. § 24, para. 7 (1976).

[43] *Id.* § 378(a).

[44] 401 U.S. at 624–25.

[45] *See, e.g.*, *id.* at 643–45 (Blackmun, J., dissenting).

[46] 401 U.S. at 630–34.

[47] 15 U.S.C. §§ 77a–77aa (1976).

of 1940,[48] but the Supreme Court would undoubtedly have held these laws applicable to the actual setup in the *Camp* case, had it been necessary to reach the question.[49] Indeed, Citibank did register its fund under these federal securities laws.[50] Nevertheless, the separate fund would be illegal under section 20 [51] and possibly section 32 [52] of the Glass-Steagall Act. The former section prohibits affiliations between member banks, such as Citibank, and securities firms, such as the underwriter firm in the hypothetical. The latter provision prohibits an officer, director, or employee of a member bank from serving as an officer, director, or employee of a securities firm. It might or might not apply, depending on whether there were any actual personnel overlaps between the bank and the underwriting affiliate.

The Federal Reserve Board's detailed "interpretation" of its rule permitting bank holding company entry into the activity of being investment adviser to an investment company attempts to obey the spirit of these provisions.[53] The interpretation expresses the Board's view that a bank holding company, including any nonbank member of the system, may not sponsor, organize, or control a mutual fund — which continuously issues shares and is thus like a securities firm in its concern with marketing of securities — though it may do these things to a closed-end fund as long as the latter is not primarily or frequently engaged in the issuance, sale, or distribution of securities. Furthermore, a bank holding company system may not engage in the sale or distribution of the securities of any investment company for which it acts as investment adviser. In other words, the only thing a bank holding company can do for a mutual fund is to provide investment management or advice. As for closed-end funds, it may also sponsor and organize them, but it cannot serve as underwriter or retail seller of the shares.

Bank trust departments, of course, can and do manage private pension plans, even when plan assets are put into common trust funds,[54] without anyone charging violations of the Glass-Steagall Act. Given the marketing endeavors of many trust departments for this kind of business, one may well question whether the existing state of affairs is consistent with the cases and rules concerning investment companies.

---

[48] *Id.* §§ 80a-1 to -52 (1976).

[49] The basis for this judgment is the Court's treatment of variable-annuity arrangements, *discussed* pp. 857-60 *infra*.

[50] Investment Co. Inst. v. Camp, 401 U.S. at 622-23.

[51] 12 U.S.C. § 377 (1976).

[52] *Id.* § 78.

[53] 12 C.F.R. § 225.125 (1978).

[54] *See, e.g., id.* § 9.18(a)(2).

What may be the most economically significant development in the aftermath of *Camp* is the permission granted Bank of America to sell undivided interests in a pool of mortgages taken from its portfolio.[55] The pool seemed very much like an investment company. Certificates of interest in minimum denominations of $100,000 were marketed by an independent investment banking firm. Soon afterwards, permission was given another bank to effect a private placement of similar certificates.[56] The mortgages were sold to a separate entity (a trust), and the bank itself was not to incur any losses as a result of defaults by mortgagors, but the bank did propose to market the certificates through its own employees rather than through an underwriter. A letter from a Deputy Comptroller opined that the use of bank employees would not be inconsistent with section 21 of the Glass-Steagall Act, because that section expressly provides that it is not to be construed as affecting in any way "such right as any bank . . . may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate."[57] The letter also noted as relevant the limited number of purchasers, their sophisticated character (mostly correspondent banks), and the minimum denomination of the certificates ($50,000), all of which suggested that the bank's proposal was not of the type which the Glass-Steagall Act intended to proscribe. The legality of various ways of marketing interests in mortgage pools is much more than an analytically interesting problem. At present, the secondary mortgage market, even with the help of quasi-governmental agencies like the Federal National Mortgage Association (Fannie Mae), is extremely small in relation to the total amount of outstanding mortgages.[58] Bank-initiated offerings of interests in mortgage

[55] Office of the Comptroller of the Currency, Release and Letter to an Officer of Bank of America, [1973-1978 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 97,093 (Mar. 30, 1977).

[56] Letter No. 25 by Charles B. Hall, Deputy Comptroller for Banking Operations, concerning Bank-of-America-type offerings of interests in mortgage pools (Feb. 14, 1978), [1978] FED. BANKING L. REP. (CCH) ¶ 85,100 (Mar. 3, 1978).

[57] *Id.* (quoting 12 U.S.C. § 378(a)(1) (1976)).

[58] According to one set of estimates, various lender groups held, as of the end of 1976, about $489.9 billion of 1-4 family residential mortgages, and total secondary market purchases throughout 1976 (by federal credit agencies, federally sponsored pools, *and* the private sector) totaled $42.8 billion. Brockschmidt, *The Secondary Market for Home Mortgages, Federal Reserve Bank of Kansas City*, MONTHLY REV., Sept./Oct. 1977, at 11, 12, 14. As of the end of 1976, total home mortgages of about $556 billion, and total mortgages of about $889 billion, were outstanding. BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS: ASSETS AND LIABILITIES OUTSTANDING 1965-1976, at 19 (1977). By comparison, total corporate equities (stocks) outstanding had an estimated market value of $989.5 billion. *Id.* at 18. One rough estimate suggests that the average holding period for equity investors appears to be about four to five years.

pools represent a type of secondary-market operation which, if it is legal and catches on, could easily involve sales of tens of billions of dollars' worth of securities in the near future.

Bank services or attempted services such as small investment account services and automatic stock purchase plans are economically of far lesser significance than most of the matters discussed above.[59] They have generated a disproportionate amount of legal controversy and astute legal commentary.[60] The arguments will not be repeated here.

4. Transactions Among Affiliates. — Most existing regulation of transactions among affiliates of bank holding companies is clearly directed to the single goal of promoting the soundness of the bank affiliates. This is not to say that the regulation is stringent. When the facts are bad enough, regulators can attack any way of tapping a bank's resources for the benefit of holding companies and their nonbank affiliate as an "unsafe or unsound practice" and can issue and attempt to enforce a cease-and-desist order.[61] Present federal law does restrict, though it does not prohibit, two principal ways of getting at bank resources — dividends to stockholders and loans to (and investments in) affiliates. Both the National Bank Act[62] and the Federal Reserve Act[63] limit banks' ability to pay dividends without prior regulatory approval, but these restraints are similar to the minimal ones affecting general business corporations.[64] With certain exceptions, the Federal Reserve Act limits loans by insured banks to any given affiliate to 10%, and loans to all affiliates combined to 20% of the bank's equity capital.[65] Direct investments in securities issued by affiliates are combined with loans when applying these limits. A loan

R. Robinson & D. Wrightsman, Financial Markets 329 (1974). This implies a ratio of volume of trading to amount of outstanding securities of about 20% to 25%, which is between 2 and 3 times greater than the ratio for home mortgages.

[59] *See* R. Pozen, *supra* note 18, at 530.

[60] *See generally* Lybecker, *Bank-Sponsored Investment Management Services: A Legal History and Statutory Interpretive Analysis* (pt. 1), 5 Sec. Reg. L.J. 110 (1977); Note, *The Legality of Bank-Sponsored Investment Services*, 84 Yale L.J. 1477 (1975).

[61] 12 U.S.C. § 1818(c)-(d) (1976).

[62] *Id.* § 60.

[63] *Id.* § 324. As for nonmember banks, state laws generally restrict dividends out of capital. *See, e.g.*, Mass. Gen. Laws Ann. ch. 172, § 24 (West 1972).

[64] *See, e.g.*, Model Bus. Corp. Act Ann. §§ 2(j), (*l*)-(m), 45(a), 46 (American Bar Foundation ed. 1971).

[65] 12 U.S.C. § 371c (1976) (member banks). The restrictions were extended to state-insured nonmember banks by the 1966 Amendments to the Bank Holding Company Act, Pub. L. No. 89-485, § 12(c), 80 Stat. 242 (codified at 12 U.S.C. § 371c (1976)). Better remedies to enforce these rules, as well as cease-and-desist orders, will soon be available. *See* Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, §§ 101, 107-108, 92 Stat. 3641 (effective Mar. 10, 1979).

to an affiliate must also be secured by collateral of specified kinds that has a market value, at the time the loan is made, of at least 110% to 120% of the amount of the loan [66] — a chilling requirement that many bankers would regard as a virtual prohibition on loans to affiliates.

Three other potentially dangerous ways of extracting bank resources are subject to fairly weak regulation. The first is the bank's payment of management fees and service charges to affiliates. Bank examiners may discover excessive fees and advise the appropriate regulatory personnel to jawbone the bank into stopping them, or to exercise cease-and-desist powers if the payments are extreme enough to constitute an unsound or unsafe practice. In addition, the Federal Reserve Board may deem the payments to be adverse "management factors" if and when it considers a later application by the bank's holding company, such as an application seeking approval of the acquisition of another bank, but this method of policing is a spotty one. A second technique is prepayment of debt owed the holding company by the bank. Particularly where (as is usual) the debt was subordinated to claims of depositors, a large payment is equivalent to a large payout of equity capital in that it increases the risk borne by depositors and the Federal Deposit Insurance Corporation. Yet prepayment of debt would not fall under the restrictions on bank dividends.[67] A third transaction that may drain a bank is a transfer of operations either to or from it. Successful operations can be transferred intact from a bank to a nonbank affiliate or, more subtly, phased over. Conversely, the holding company may transfer lackluster operations to the bank.

5. Managerial Overlaps. — When two or more banks are interlocked and they have a significant number of common managers (directors or officers), certain undesirable behavior may be facilitated. The banks may agree more readily to restrict competition, thus harming the interests of bank customers. Or the interlock may facilitate improperly favorable loans among the managers, threatening the interests of bank shareholders or even jeopardizing bank soundness.

Despite the theoretical possibility that interlocks might facilitate self-dealing schemes, the surprisingly intricate federal regulation of interlocks involving depository financial institutions is based almost entirely on antitrust concerns.[68] Section 8 of the

---

[66] 12 U.S.C. § 371c (1976).

[67] Where a regulator must approve issuances of the debt, however, he might impose conditions on prepayment.

[68] *See generally* Wiley, *Federal Regulation of Interlocks Involving Financial Depositories*, COUNSEL, Spring 1977, at 1. On the special problem of bank-

Clayton Act [69] contains two distinct prohibitions: a *general* prohibition against interlocking directorates between competing business corporations, one of which has a net worth exceeding $1 million; and a *special* prohibition against bank interlocks involving a director, officer, or employee of a member bank. The special bank interlock prohibition is confined to interlocks between a member bank and any other "bank, banking association, savings bank, or trust company, organized under the National Bank Act or state law." [70] Accordingly, it does not forbid interlocks between a bank and a nonbank company, regardless of whether the latter is affiliated through stock ownership with the former. In addition, there are a number of express statutory exemptions. For instance, there is an exemption for interlocks between a member bank and a bank not located in the same or a contiguous or adjacent city, town, or village. This exemption is obviously based on the notion that such banks are less likely to be competitors of one another, at least with respect to many banking activities. The fact that two banks are geographically separated, however, hardly seems a reason to suppose that if interlocked they would be less prone to managerial conflicts of interest than two adjacent interlocked banks. The lack of concern for the soundness objective is shown even more clearly by the express exemption that permits interlocks between a member bank and a bank more than fifty percent of the common stock of which is owned directly or indirectly by persons owning over fifty percent of the common stock of the member bank.[71] Recently enacted bank regulation imposes even stricter regulation of management interlocks involving depository institutions and depository holding companies, but again the concern is with antitrust dangers: the prohibitions are based on the geographical proximity and size of institutions and do not apply to intra-system interlocks.[72]

B. Insurance Holding Companies

1. Acquisitions of Insurance Companies. — As a result of a wave of acquisitions of insurance companies in the 1960's, two major studies were undertaken, by a Special Committee on In-

---

S & L interlocks, see Comment, *Interlocks in Management between Savings and Loan Associations and Commercial Banks under the Antitrust Laws and the FTC Act*, 65 GEO. L.J. 1263 (1977).

[69] 15 U.S.C. § 19 (1976).

[70] *Id.*

[71] *Id.*

[72] Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, §§ 203-204, 92 Stat. 3641 (effective Mar. 10, 1979).

surance Holding Companies in New York and by the National Association of Insurance Commissioners (NAIC).[73] The former produced a well-known report,[74] which led eventually to legislation in New York.[75] In June 1969, the NAIC finally approved model legislation for an Insurance Holding Company System Regulatory Act (the Model Act),[76] which was eventually adopted, with minor variations, in forty-six states and the District of Columbia.[77] Those states, such as New York, that did not adopt the Model Act tended to have holding company regulations which were quite similar.[78]

The Model Act, based on the premise that insurance holding companies were not per se inimical to the interests of policyholders and shareholders, is heavily oriented to "disclosure imposed on domestic insurers, subject to verification by examination." [79] It deals with the acquisition of control of insurance companies, regardless of whether the acquirer is a corporation or natural person,[80] provides for registration and regulation of members of holding company systems, and deals specially with subsidiaries of insurance companies.

The acquisition-of-control provisions require that a person seeking control of an insurer formed under the laws of the state give prior notice of the proposed acquisition to that state's regulatory agency and to the target insurance company.[81] The notice consists of a detailed statement of the identity and financial condition of the acquirer and its intentions with regard to the insurance company. The content of the required notice is similar to that required under the Williams Act [82] in the case of

---

[73] *See generally* Note, *The Insurance Holding Company Phenomenon and the Search for Regulatory Controls*, 56 VA. L. REV. 636 (1970).

[74] State of New York Insurance Dep't, Report of the Special Committee on Insurance Holding Companies (Feb. 15, 1968).

[75] N.Y. INS. LAW §§ 69-a to -k (McKinney Supp. 1978-1979). *See also* 11 N.Y. CODE R. REG. §§ 80.2-7 (1969).

[76] 2 NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, OFFICIAL N.A.I.C. MODEL INSURANCE LAWS, REGULATIONS, AND GUIDELINES 440-1 to -14 (1977) [hereinafter cited as Model Act].

[77] For a detailed analysis of the provisions of insurance holding company statutes, including variations among states, see Schwing, *Insurance Holding Company Regulatory Statutes and Related Legislation: A Comparative Analysis*, 27 FED'N INS. COUNSEL Q. 96 (1976).

[78] *See* note 75 *supra*.

[79] Demichelis, *The Holding Company and the Insurance Regulatory System*, SPECTATOR, Apr. 1970, at 46.

[80] Model Act, *supra* note 76, §§ 1(a), 3(a), (d) (required filing and approval in connection with acquisition by a "person," including an individual); *cf.* Bank Holding Company Act §§ 2(b), 3, 12 U.S.C. §§ 1841(b), 1842 (1976) (acquisition provisions applied to any "company," a term which does not include individuals).

[81] Model Act, *supra* note 76, § 3.

[82] *Compare id.* § 3(b) *with* Securities Exchange Act of 1934, §§ 13(d), 14(d),

attempted takeovers of any public corporation governed by that Act. The state regulatory agency is required to hold a public hearing on the proposed acquisition. This requirement of a hearing and prior notice is strikingly similar to corresponding rules of the numerous state antitakeover statutes governing all business corporations that were enacted about a decade after approval of the Model Act.[83] The similarity is not inexplicable, for the Model Act was quite definitely intended by some of its supporters to be an antitakeover statute.[84]

Within thirty days of the conclusion of the hearing, the insurance commissioner must approve or disapprove the takeover. He is required to approve the acquisition unless he finds that: (1) after the acquisition the insurer would not be able to satisfy the requirements for the issuance of a license to write the lines of insurance for which it was previously qualified, (2) the acquisition would substantially lessen competition or tend to create a monopoly in insurance in the state, (3) the financial condition of the acquiring party might jeopardize the financial stability of the insurer or prejudice the interest of the policyholders or any security holders remaining unaffiliated with such acquirer after the acquisition, (4) the terms of the offer are unfair and unreasonable to the security holders of the insurer, (5) the acquiring party's plans for the insurance company are unfair and unreasonable to the policyholders and not in the public interest, or (6) the competence, experience, and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policyholders or the public to permit the merger or other acquisition of control.[85]

One can discern in these substantive tests the same two major objectives that underlay the tests in section 3(c) of the Bank Holding Company Act. The second test is clearly a reflection of antitrust concerns. The first and third tests directly relate to the soundness objective, while the fifth and sixth are cast in terms of policyholder protection and thus are indirectly oriented to that objective. In addition, however, the Model Act, in the fourth test, reflects an objective that case law has clearly ruled out of the area of policy concern of the Bank Holding Company Act, namely, insuring the substantive fairness of

15 U.S.C. §§ 78m(d), 78n(d) (1976), *and* SEC regulation 14D, schedule 14D, 17 C.F.R. §§ 240.14d-1 to -101 (1978).

[83] *See* Wilner & Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1, 8–9 (1976).

[84] *See* Demichelis, *supra* note 79, at 44; *Regulators Eye Insurance Funds*, BUS. WEEK, Jan. 2, 1971, at 36.

[85] Model Act, *supra* note 76, § 3(d)(1)–(2).

an acquisition to the shareholders of the intermediary.[86] This additional objective is a simple consequence of the Model Act's origin in a legal movement that was largely fueled by desires of insurance company managers to hinder takeovers.

2. Noninsurance Activities of Insurance Companies. — In addition to imposing very conservative restrictions on the kinds of securities in which insurance companies may invest,[87] state law usually limits the business activities of life insurers.[88] For example, life insurance companies doing business in New York are limited principally to life insurance, annuities, accident and health insurance, related reinsurance activities, and "such other business as is necessarily or properly incidental thereto." [89] They may also engage in four of the twelve activities permitted to subsidiaries of domestic life insurers, including rendering investment advice; rendering services related to the functions involved in the operation of an insurance business, such as actuarial, loss prevention, and data processing services; acting as administrative agent for a governmental instrumentality performing an insurance function or responsible for a health or welfare program; and any other business "reasonably ancillary" to an insurance business. The company can only engage in these activities, however, to the extent necessary or properly incidental to its regular insurance business, or to the extent approved by the insurance superintendent, who may impose limitations on the activities in order to protect policyholders.[90] In giving approval and imposing limitations, the superintendent must take into account the effect of the proposed activity on the insurer's existing business and surplus, proposed cost allocations, the risks inherent in the activity, and the advantages to the insurer and policyholders of conducting the activity directly rather than through a subsidiary.

These provisions make it clear that the law's activity limitations are mainly concerned with keeping the insurer financially sound. A more subtle separation of activities is that life insurance companies are not authorized to carry on property and liability insurance activities. The latter are commonly thought to be riskier than life insurance and annuities and must be carried on in separate corporations.

3. Noninsurance Activities of Insurance Holding Company Systems. — In sharp contrast to bank holding companies, insurance holding companies are not generally restricted in the types

---

[86] *See* note 16 *supra*.

[87] *See* Clark, *supra* note 4, at 44 n.125.

[88] Wolke, *Curing the Cure — Insurance Holding Companies*, 6 FORUM 95, 100 (1971).

[89] N.Y. INS. LAW § 193(1)-(2) (McKinney Supp. 1978-1979).

[90] *Id.* § 46-a(9).

of businesses in which they may engage. Of course, the members of the holding company system that are insurance companies must confine themselves mainly to insurance activities and, as discussed below, there are limits on what subsidiaries of life insurance companies can do. But, so far as state insurance laws are concerned, the insurance holding company and its noninsurer subsidiaries may engage in any kind of business, including nonfinancial businesses. One should not conclude, however, that the law displays no concern whatever for the placement of an insurance company within a holding company system and for the connections that may exist between the insurer and other companies within the system. The Model Act has a number of special provisions that reflect a fear of intrasystem self-dealing and are consequently solicitous of the insurer's soundness.[91] These provisions are discussed in the next subsection.

Subsidiaries of insurers make up an important special category because many large insurance companies are mutual in form and therefore cannot be controlled by traditional "upstream" holding companies. Mutual insurers wanting to branch out into other endeavors had to form "downstream" companies.[92] This was cause for legislative concern, for the riskiness of a subsidiary will affect more surely the soundness of an intermediary than will the riskiness of any of its other affiliates. Subsidiaries of life insurance companies are generally restricted in ways reminiscent of the activity restrictions on bank holding companies.[93] Under New York law, which is quite similar to the Model Act, a life insurance company, subject to various exceptions, may have only subsidiaries that are organized to engage exclusively in one or more of several listed activities.[94] The most open-ended residual category is "any other business activity reasonably ancillary to an insurance business"[95] — a provision remarkably similar to the "closely related" test of the Bank Holding Company Act. Most of the specific businesses listed in the other clauses of the statutory provision, such as acting as insurance agent for the parent insurance company or any of its insurer subsidiaries, are obviously ancillary to insurance, but some concern investment banking and investment management activities. An insurance subsidiary may engage in

[91] Model Act, *supra* note 76, §§ 4–6.

[92] Wolke, *Insurance Companies as Parents and Subsidiaries*, 1970 ABA INSURANCE, NEGLIGENCE & COMPENSATION SECTION 166, 168.

[93] *Compare* Model Act, *supra* note 76, § 2(a), *with* rules for bank holding companies discussed pp. 796–98 *supra*.

[94] N.Y. INS. LAW § 46-a(1) (McKinney Supp. 1978–1979).

[95] *Id.* § 46-a(1)(k). The phrase also appears in Model Act, *supra* note 76, § 2(a)(11).

securities trading and act as a securities broker or dealer for its own account or that of its affiliates. A subsidiary of a life insurer may also provide management, sales, or related services, as well as investment advice, to an investment company. Unlike bank holding company systems, therefore, insurance holding company systems can get into the business of sponsoring and marketing mutual funds, not just advising them. This important difference helps explain why bank holding company involvement in mutual funds has been minimal, whereas by 1974 nearly half of all mutual funds were managed by insurance companies or their affiliates.[96]

Under the New York scheme, life insurance companies must give advance notice of proposed acquisitions of subsidiaries to the superintendent of insurance, who may disapprove the proposed acquisition if he finds it contrary to the best interest of the parent insurer's policyholders or the people of the state. The relevant statutory provision lists seven factors that he is to consider in making this determination.[97] All but one relate to the soundness of the insurer or to possible anticompetitive effects of the acquisition; the remaining factor is the fairness and adequacy of the financing proposed for the subsidiary.

In summary, insurance holding companies and their noninsurer subsidiaries are virtually free of activity restrictions. Subsidiaries of life insurance companies may not engage generally in nonfinancial activities. By virtue of the Bank Holding Company Act, they usually may not engage in commercial banking.[98] But they may engage in businesses reasonably ancillary to insurance, a concept interpreted broadly to include limited broker-dealer activities (for the subsidiary or its affiliates, though not for the general public); general investment-advisory services; and the sponsoring, managing, and marketing of investment companies. To make a more complete comparison with the discussion of bank holding companies, I should also note that insurance companies can manage pension plans. They have long competed with bank trust departments and other investment advisors for this business.[99] They can also set up "separate accounts" within the insurance company for variable annuity

---

[96] Pitti, *The Competition for Financial Services: A Marketing Revolution*, BEST'S REV., Dec., 1975, at 20, 22.

[97] N.Y. INS. LAW § 46–a(2)(b) (McKinney Supp. 1978–1979).

[98] If an insurance company controlled a bank, it would be a bank holding company. But a bank holding company (or its nonbanking subsidiaries) generally cannot underwrite insurance risks, unless they are related to extensions of credit by the bank of an affiliate. 12 U.S.C. §§ 1841(a), 1843(a)–(c)(8) (1976); regulation Y, 12 C.F.R. § 225.4(a)(10) (1978).

[99] *See* 2 SEC, INSTITUTIONAL INVESTOR STUDY REPORT 545–55 (1971).

and variable life insurance programs[100] that are analogous to the "commingled managing agency account" held in *Camp* to be illegal for a national bank to operate. To simplify, insurance companies but not banks can operate internal, "disguised" investment companies.

4. Transactions Among Affiliates. — Whereas the federal Bank Holding Company Act virtually ignores the subject of transactions within the holding company system, leaving such regulation of interaffiliate dealings as there is to other banking statutes, the Model Insurance Holding Company System Regulatory Act has numerous provisions directed at the problems created by such transactions. Under the Model Act, an insurer which is a member of a holding company system must file a detailed registration statement. It must disclose the identity of every other member of the holding company system, as well as various agreements, relationships, and transactions between the insurer and any of its affiliates if they are "material" — that is, if they involve more than one-half of one percent of the insurer's admitted assets as of the end of the preceding year.[101] Transactions with affiliates must be fair and reasonable.[102] More important — since a fairness test of this sort presumably governs dealings among any kinds of affiliated business corporations — the records of each party must clearly disclose both the nature and details of the transactions, so that insurance examiners may have a good documentary basis for judging the fairness of the transactions, and "the insurer's surplus as regards [its] policyholders . . . [must] be reasonable in relation to [its] outstanding liabilities and adequate to its financial needs."[103] In the case of extraordinary dividends or distributions made by an insurer, advance notice must be given to the insurance commissioner, who may disapprove the transaction.[104] Furthermore, the Model Act extends the examination powers of state insurance departments. When necessary to ascertain an insurer's financial condition or the legality of its conduct, the insurance commissioner can order the insurer to produce records in the possession of its affiliates and, if the insurer fails to comply with the order, can examine the affiliates themselves.[105] The important New York provisions on insurance holding companies go even further.[106]

[100] *See* pp. 858–60 *infra*.

[101] Model Act, *supra* note 76, § 4.

[102] *Id.* § 5(a)(1).

[103] *Id.* § 5(a)(2)–(3).

[104] *Id.* § 5(c).

[105] *Id.* § 6.

[106] For example, advance approval of the superintendent of insurance is required for certain material transactions between an insurer and its affiliate, *e.g.*,

5. Managerial Overlaps. — The Clayton Act's general prohibition of interlocks between competing businesses does apply to insurance companies, though not to banks, which are governed by the special prohibition.[107] State insurance laws generally display no more severe restraints. Indeed, some insurance holding company statutes state explicitly that common management of system members is permitted.[108] As with banks, interlock provisions are in fact geared to antitrust concerns rather than the intermediary's soundness.

C. Savings and Loan Holding Companies

1. Acquisitions of S & L's. — Under the Savings and Loan Holding Company Amendments of 1967,[109] when an acquisition of a savings and loan association (S & L) insured by the Federal Savings and Loan Insurance Corporation (FSLIC) is made by a company that is not already a savings and loan holding company, the acquirer must have the prior written approval of the FSLIC. The Corporation must approve the acquisition unless it finds the financial and managerial resources and future prospects of the institution involved to be such that the acquisition would be detrimental to the institution or the insurance risk of the Corporation.[110] When the acquisition is by a company that is already a savings and loan holding company or is to be an acquisition of more than one insured institution, the procedure and substantive standards are quite similar to those governing bank acquisitions under the Bank Holding Company Act. The same three-part substantive standard, phrased in almost identical wording, is used.[111]

2. Activities of S & L's. — Statutes general define the permitted activities of savings and loan associations more narrowly than those of any other kind of financial intermediary. Federally chartered associations may offer conventional sorts of savings accounts and related services to their account holders; may invest their funds in loans secured by mortgages on homes, in

---

a sale or purchase of securities involving more than five percent of the insurer's admitted assets. Advance notice, with a 30-day opportunity for the superintendent to disapprove, is required of certain less material transactions. *See, e.g.*, N.Y. INS. LAW § 69–e(2) to (3) (McKinney Supp. 1978–1979).

[107] 15 U.S.C. § 19 (1976).

[108] *E.g.*, N.Y. INS. LAW § 69–g(2) (McKinney Supp. 1978–1979).

[109] Pub. L. No. 90–255, 82 Stat. 5 (1968) (current version at 12 U.S.C. § 1730a (1976)).

[110] 12 U.S.C. § 1730a(e)(1)(B) (1976).

[111] *Id.* § 1730a(e)(2); *see* H.R. REP. No. 997, 90th Cong., 1st Sess. 21–22, *reprinted in* 2 [1968] U.S. CODE CONG. & AD. NEWS 1601, 1611–13. *See* pp. 792–95 *supra*.

certain very conservative securities, and (within precise limitations) in expressly listed types of other loans thought very safe or deserving of congressional encouragement; and may not do much else.[112]

3. Activities of Savings and Loan Holding Companies. — The law concerning savings and loan holding companies is dichotomized in a way that was characteristic of the Bank Holding Company Act before the important amendments in 1970. Under the applicable federal law, one-association savings and loan holding companies are not governed by activity restrictions, but multiple savings and loan holding companies are.[113] As for the multiple companies, the rules are similar to those governing nonbank subsidiaries of bank holding companies. A multiple savings and loan holding company or a subsidiary of it that is not an insured institution may not engage in any business activity other than furnishing or performing management services for a subsidiary insured institution, conducting an insurance agency or escrow business, managing assets owned by or acquired from a subsidiary insured institution, holding or managing properties used by such an institution, acting as a trustee under deed of trust, or engaging in such other activities as the Federal Savings and Loan Insurance Corporation may approve or prescribe by regulation as being a "proper incident" to the operation of insured institutions and "not detrimental to the interests of savings account holders therein." [114] The regulations under the "proper incident" language permit non-S & L affiliates to engage in activities such as originating, buying, selling, and servicing certain kinds of loans; performing accounting services for affiliates; performing data processing research, advertising, and other kinds of services for affiliates or for other insured associations or their affiliates; and underwriting credit insurance in connection with extensions of credit by affiliates or by other insured associations and their affiliates.[115] Most significantly, the holding company affiliates may engage in acquiring, developing, renting, and managing real estate [116] — activities generally prohibited to bank holding company affiliates.[117] On the other hand, multiple savings and loan holding companies may not set up broker-dealer affiliates or otherwise engage in investment banking, nor may they set up general investment advisory firms or sponsor and market investment companies.

---

[112] 12 U.S.C. § 1464(c) (1976).

[113] *Id.* § 1730a(c)(2).

[114] *Id.*

[115] 12 C.F.R. §§ 584.2–1(b), .2(c), 545.9–1(a)(4) (1978).

[116] *Id.* § 584.2–1(b)(4) to (8).

[117] *See* regulation Y, 12 C.F.R. § 225.4(a) (1978).

These differences in the permitted activities of the two major types of depository institution holding companies reflect differences in the services permitted to banks and savings and loan associations. Although the latter may not themselves develop real estate, for example, their lending and investment activities involve them much more frequently and intimately in real estate transactions than do the lending and investment activities of most commercial banks. And banks with trust departments, though they do not advise investment companies themselves, engage in investment advisory services to a far greater extent than do savings and loan associations. Thus, the regulatory interpretations of the "closely related" and "proper incident" tests have been geared, as they should be, to the particular type of intermediary activity that gives rise to the regulatory test.

The Bank Holding Company Act, as mentioned, has both a "closely related" test and a "public benefits" test. The parallel in the Savings and Loan Holding Company Amendments of 1967 to the latter test is much simpler — a requirement that holding company activities not be detrimental to the interest of savings account holders.[118] The goal is to ensure the soundness of the association; no mention is made of antitrust objectives.

4. Transactions Among Affiliates. — Unlike the Bank Holding Company Act, the Savings and Loan Holding Company Amendments of 1967 contain major provisions restricting transactions among affiliates. They all reflect a concern that the subsidiary insured associations will be milked for the benefit of the holding company's other enterprises. At the same time, they mesh with the provisions covering the permitted activities of holding company affiliates. Many of those affiliates will be organized to provide services for the insured association, and the self-dealing provisions therefore do not prohibit sales of assets and services by affiliates to the appropriate associations.

Under the statute, a subsidiary insured association must give advance notice to the FSLIC of proposed dividends,[119] in order that the Corporation may react to dangerous depletions of the association's resources. The statute also attempts to cool the temptation to expect large dividends from subsidiary associations. With an exception for so-called diversified holding companies (such as Sears, Roebuck and Co.),[120] a savings and

---

[118] 12 U.S.C. § 1730a(c)(2) (1976).

[119] *Id.* § 1730a(f).

[120] *Id.* § 1730a(g)(2); *see* T. MARVELL, THE FEDERAL HOME LOAN BANK BOARD 211, 215 (1969). Roughly, a "diversified" savings and loan (S & L) holding company is one whose subsidiary insured S & L association and related activities (those that are a proper incident to the S & L business) account for less than

loan holding company may not incur debt in excess of fifteen percent of its net worth without the approval of the Corporation, which is to concern itself with possible financial injuries to the subsidiary insured associations.[121] Investments by the association in stock or debt of the affiliates, as well as loans and guarantees of loans to affiliates, are basically forbidden.[122] Sales of assets, for example, portfolio securities, between the association and an affiliate, as well as agreements by an affiliate to provide management, advertising, consulting, and other nonexempt services to the association, require the prior written approval of the Corporation if they involve amounts exceeding the lesser of $100,000 or one-tenth of one-percent of the association's assets.[123] The standard of approval is interesting because, rather than mimicking the all-purpose test of fairness used in most corporate statutes covering self-dealing, it directly expresses the soundness objective: the transaction or agreement must not be detrimental to the interest of the association's savings account holders or to the insurance risk of the Corporation.[124] Neither majority nor minority shareholders of the association are the objects of the statutory protection.

5. Managerial Overlaps. — Although there may be overlaps within a holding company system, a director, officer, or controlling person of a savings and loan company may not, without the Corporation's prior approval, serve as a director, officer, or employee of an insured association not within the system, or of another savings and loan holding company.[125] Recent legislation imposes prohibitions on interlocks with bank holding company systems.[126]

II. POLICY: ASSESSMENT OF THE ALLEGED CONSEQUENCES OF FINANCIAL HOLDING COMPANIES

A. The Basic Reason for the Separation Theme

The major reason for the enormous amount of special regulation of financial intermediaries, as opposed to nonfinancial business corporations, is to insure their soundness, in order that their public suppliers of capital may be protected against the

50% of its consolidated net worth and less than 50% of its consolidated net earnings. 12 U.S.C. § 1730a(a)(1)(F) (1976).

121 12 U.S.C. § 1730a(g) (1976).

122 *Id.* § 1730a(d)(1)-(5).

123 *Id.* § 1730a(d)(6).

124 *Id.*

125 *Id.* § 1730a(i)(2).

126 *See* note 72 *supra*.

risk of the intermediaries' financial failure.[127] In the light of this dominant policy, one may perceive the most basic reason for the separation theme: absent countervailing considerations, intermediary businesses ought to be kept separate from other lines of business in order to facilitate the regulators' task of achieving soundness. Regulators can create cheaper, simpler, and more uniform reporting and recordkeeping requirements, accounting rules, examination procedures, and substantive risk-related rules if they do not have to contend with the possible impact on the intermediary business of other operations of the regulated entity.

Depending on the riskiness of the stream of earnings generated by an associated nonintermediary business and its covariance with the earnings stream of the intermediary business, the nonintermediary business may increase or reduce the risk of financial failure of the enterprise as a whole. If the combination of businesses is allowed, the regulators of the intermediary will have several extremely arduous additional tasks: assessing both the independent degree of riskiness of the nonintermediary business and the way it contributes to overall riskiness, and articulating and enforcing more complex rules for reducing risk posed to public creditors of the intermediary or properly compensating their insurers. Nor would it generally be wise to shorten the task by simply requiring the nonintermediary business, no matter what it is, to be run in an extremely safe way, for such a decision would entail its own monitoring and enforcement costs and might force the business to be operated inefficiently.

Since the basic objective is simply to lower the costs of administering soundness regulation by making it less complex, the decision generally to isolate the specially regulated intermediary businesses does not entail an absolutely pure or ruthless isolation. Trying to achieve *total* excision of nonintermediary activities may be administratively costly, because it leads to an obsession with definitional issues — which functions are and are not inherent in "banking" and "insurance." The additional administrative cost savings of prohibiting a particular function may be negligible, while the intermediaries carrying out the function may yield benefits to themselves or customers. A more important point, however, is that administrative cost savings and other plausible goals [128] of the isolation are not certain to be served merely because the intermediary business is kept within a separate corporate shell. That separation is indeed the obvious first step. But the corporate veil is not a totally impermeable

[127] *See* Clark, *supra* note 4.
[128] *See* pp. 829–33 *infra*.

membrane. Many of the problems and dangers posed by combining intermediary and nonintermediary businesses within the same legal entity may be posed by combining them in a system of legal entities under common control — that is, in a holding company.

The following examination of possible problems presented by financial holding companies attempts to grapple with a central question: are there valid reasons, other than administrative convenience in administering soundness regulation, for rules expressing the separation theme? It also considers whether there are positive reasons for limiting or reducing separation regulation.

B. Alleged Consequences of Financial Holding Companies

In an attempt to make sense of the regulation of financial holding companies, I will examine a large number of alleged consequences of financial holding companies. The first nine consequences are more likely to be anticipated by intermediary managers and to motivate them to form holding companies. The other consequences are less likely to have served as a source of motivation. In either case my effort will be to assess whether the alleged consequences actually occur to a significant degree and, if so, whether they are good or bad. Good consequences should give a legislature pause when it considers whether to regulate financial holding companies, or should at least encourage it to regulate in the least restrictive way needed to achieve its goals. Knowing the consequences that really pose serious public policy problems will help it to decide which kinds of regulation are appropriate.

1. Positive Reasons for Holding Company Formation. — *(a) Overcoming Geographical Constraints on Doing Business.* — Holding companies may enable financial intermediaries to overcome geographical constraints. If, for example, state law prohibits commercial banks from establishing branches in any county other than that of the principal office of the bank, a bank's management and shareholders may cause it to become a subsidiary of a holding company, which in turn will establish separate, subsidiary banks in other counties or will acquire a controlling interest in the stock of existing banks in other counties. The federal Bank Holding Company Act does not forbid such arrangements, nor do the holding company laws of some states.[129] The bank may therefore accomplish, via the

[129] *See, e.g.*, MASS. GEN. LAWS ANN. ch. 167A (West 1971 & Supp. 1979); GA. CODE ANN. § 13-207.1 (Supp. 1978).

holding company, a kind of ersatz statewide branching.[130] Nor is this use of the holding company device limited to cases where the bank wants to extend its banking business. Banks can legally engage in certain nonbanking lines of business, but management may feel that good business opportunities are lost by restricting those activities to places where branches or affiliated banks may be located. Accordingly, management may form a company to hold the stock of both the bank and of nonbanking subsidiaries, which may be located anywhere in the country. The technique may also be used by other intermediaries. For example, an insurance company wishing to do a limited line of business in another state, but not wanting to qualify the entire company to do business there, may find it more convenient to set up an affiliate company to carry on the limited business.

Whether one considers this ability to overcome legally imposed geographical barriers a good thing depends on one's view of the merits of such restrictions. The conclusion adopted here from prior analytic work is that branch banking laws generally constitute undesirable, anticompetitive restraints, the alleged public purposes of which are better served by other existing regulatory devices.[131] "Branching" via the holding company technique is therefore a welcome phenomenon and should not constitute a basis for restrictive regulation. While branching laws are on the books, of course, so-called affiliates that operate as branches in all respects should be treated by judges as subterfuges; the de facto branching doctrine[132] already recognizes this principle. But there is no reason for a legislator to accept the existence of branching laws as a justification for present holding company statutes or proposed extensions of them.[133] As for the geographical selectivity employed by insurance holding

[130] Restrictions on branch banking have always been cited as a major cause of bank holding company growth. Savage, *A History of the Bank Holding Company Movement: 1900–1978*, in Staff of the Board of Governors, Federal Reserve System, The Bank Holding Company Movement to 1978: A Compendium § 2, at 6 (Apr. 12, 1978) [hereinafter cited as Federal Reserve Staff Compendium].

[131] Clark, *supra* note 4, at 28–32, 44, 101.

[132] *See* note 16 *supra*.

[133] Indeed, he should be moved to repeal the branching prohibitions, for some of the economies of operation or advantages to customers that induce branching may not be achievable by a holding company system. For example, a bank in a holding company system may be afraid to let a customer deposit funds at its offices to the customer's account with another bank in the system, or to withdraw funds from that account. *See* First Nat'l Bank v. First Bank Stock Corp., 306 F.2d 937 (9th Cir. 1962). On the advantages of branch banking, see P. HORVITZ, MONETARY POLICY AND THE FINANCIAL SYSTEM 110–15 (3d ed. 1974).

companies, it does not seem to constitute a strong case for additional regulation.[134]

(*b*) *Tax Considerations and Investment Opportunities.* — Holding company systems may for the benefit of shareholders avoid a significant "tax waste." Consider an intermediary with sizable earnings but with investment opportunities in the intermediary business that, because of a combination of business factors and regulatory constraints, offer an expected risk-return matrix significantly inferior to those of other business opportunities known to management. In a tax-free world, the normatively correct thing for the managers to do would be to declare dividends and inform the shareholders that they might better invest their money elsewhere. But in the real world large dividends invoke very large individual income taxes at the shareholder level. There might also be significant costs involved in reaggregating stockholder money to take advantage of new opportunities. Therefore, even a management concerned only with maximizing shareholder wealth might choose to retain earnings for investment in the intermediary-type opportunities, which are, from a business standpoint, inferior. The inferiority of the risk-adjusted earnings from the new investment might be more than matched by tax savings, if all earnings are retained and each shareholder ultimately cashes in on the value of his share of them by selling stock and being taxed at long term capital gains rates.[135] A third alternative, however, is for the intermediary's management to set up a parent holding company, declare the intermediary's earnings as a nontaxable intercorporate dividend,[136] and contribute the money as a tax-free contribution to the capital of a new subsidiary[137] that can engage in the more profitable, nonintermediary business opportunities. In this way, the tax advantages of retaining earnings can be combined with

---

[134] After all, the state in which the subsidiary or affiliate does business will usually apply its safeguards, including capitalization requirements and surplus requirements, in full force to that company; the solidity of related entities is not its direct concern. Nevertheless, some insurance commissioners appear to have felt a need to be able to examine related companies. State of New York Insurance Dep't, *supra* note 74, at 52.

[135] The advantages of the technique are explained in Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*. 87 YALE L.J. 90, 102 nn.43 & 45, 110 n.81 (1977). Exactly what the tax advantages (if any) will be depends on characteristics of the shareholders, *e.g.*, whether their situation is such that a prohibitively high tax rate will be applied to their capital gains. Recent legislative action to reduce the maximum tax on capital gains encourages use of the retained earnings strategy. *See* Revenue Act of 1978, P.L. 95-600, § 402, 92 Stat. 2867 (increased capital gain deduction for individuals).

[136] I.R.C. § 243.

[137] I.R.C. § 118.

more efficient use of investable funds, despite activity restraints on the intermediary itself.

So long as the tax law tolerates the retained earnings strategy by not imposing a shareholder-level dividend tax on corporate earnings until earnings ultimately come out of corporate solution (regardless of how many "layers" of corporate solution there are), then there is nothing objectionable about this reason for the formation of holding companies. Indeed, the technique is a good one, for the increased efficiency it permits is a social as well as a private efficiency. If this reason for holding company formation is one that actually motivates businessmen,[138] then that fact argues against any regulation flatly prohibiting holding company systems.

(c) *Increasing Efficiency.* — A financial holding company system and, in many respects, any other conglomeration of businesses under one management, may increase efficiency in various ways. First, a conglomerate may be able to reap economies of scale in raising capital.[139] Second, a financial holding company system may allow the financial intermediary to sell excess services that it would not be allowed to market on its own. Doing this may be efficient when the intermediary business and the other service have different patterns of returns to scale. For example, an efficiently sized data processing unit may have more capacity than the bank that owns it can use; it would be desirable to have some way of selling the excess capacity. Third, transactions among divisions or affiliates of a multiunit business may, under special conditions, be less costly than comparable transactions in the open market, in that they may entail reduced transaction and information costs and permit superior coordination of activities. Such economies have been adduced, for example, to account for some firms' attempts at vertical integration.[140] Conceivably, they may justify some transactions between

---

[138] Whether it does is difficult to observe directly. Managers understandably do not like to compare what they do to the hypothetical alternative of handing over the company's resources to the shareholders. On the other hand, the need to handle a profitability crisis has been alleged as a major reason for expansion via holding companies into nonintermediary businesses. *See, e.g.*, Note, *supra* note 73 at 639; Kemper, *Insurance Holding Companies: Economic and Management Factors*, 1969 ABA INSURANCE, NEGLIGENCE & COMPENSATION SECTION 323, 326.

[139] If a financial holding company raises capital (debt or equity) cheaply, it can pass the benefit on to its subsidiary financial intermediaries (or to other subsidiaries) by making contributions to their equity capital. The Federal Reserve Board has occasionally stated that an acquired firm will become a more effective competitor because of better access to capital through the acquiring holding company. *See, e.g.*, Union Trust Bancorp, 62 Fed. Res. Bull. 802, 803 (1976).

[140] *See* A. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 6–7, 363–65 (1977).

intermediaries and their affiliates. Since they are relevant mainly as reasons for permitting conflict-of-interest situations to persist, consideration of them will be postponed to the discussion of fraud and self-dealing.[141] Fourth, since a conglomerate usually takes what Oliver Williamson calls a multidivisional form (M-form) as opposed to a unitary form (U-form),[142] it may be a superior way of controlling underperformance and self-dealing by personnel at levels other than the very top.

Because Williamson's argument about the M-form method of doing business yields an important reason for allowing formation of financial holding companies with nonintermediary subsidiaries, even if interaffiliate transactions were to be outlawed, it should be explored at some length.[143] The multidivisional form of business organization is like a small capital market that has certain desirable properties. If one division or subsidiary is not performing as well as others, top management can easily decrease the budget of that "firm" within the firm and reward the other "firms"; it can readily dismiss underperformers and promote achievers. The principal mechanism by which the open market effectively disciplines managements of separate corporate firms is the takeover.[144] Yet takeovers have serious drawbacks. They are not suitable for fine tuning of rewards and punishments to incumbent executives, whereas the top management of a conglomerate firm can set the budget available to the manager of a particular division or subsidiary at any one of many values. Furthermore, they are not infrequently unsuccessful — a problem rarely faced by the top managers of a conglomerate when they want to shift around the lower level executives or change budgets. They are also very expensive.[145] This expense results

[141] *See* pp. 828–33 *infra*.

[142] O. WILLIAMSON, CORPORATE CONTROL AND BUSINESS BEHAVIOR 116, 118 (1970). Williamson's analytical works depend heavily upon the historical research and interpretations put forth in A. CHANDLER, STRATEGY AND STRUCTURE (1962).

[143] Williamson summarizes the advantages of the M-form organization in O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 137–48 (1975).

[144] *See* Hindley, *Separation of Ownership and Control in the Modern Corporation*, 13 J.L. & ECON. 185, 186–87 (1970) ("market for corporate control" is most plausible constraint on managers). The statement in text may seem inconsistent with reports that many target firms have been profitable and are heavy with liquid assets. But a firm "well managed" in the sense that it has these characteristics may be *suboptimally conservative* from an economic point of view; it may not be taking "enough" risk if a different use of its liquid assets would produce a greater return per unit of risk.

[145] In one study, per-share transaction costs were found to be about 14% of the market value of the share after a successful offer. R. Smiley, The Economics of Tender Offers 124–125 (1973) (unpublished Ph.D. dissertation, Stanford University), *cited in* O. WILLIAMSON, *supra* note 143, at 143 n.6.

from the cost of searching for underperforming firms, from the more business-oriented tasks of acquisition such as those carried on by underwriters and accountants, and from the need to comply with complex regulations and to fight extended legal battles based on a wide array of laws and regulations, ranging from antitrust objections to state antitakeover statutes. By contrast, the top managers of a conglomerate already have sunk funds into obtaining good information about how their divisions are really performing, they need less outside help in rearranging matters, and when they fire executive personnel or curtail divisional budgets they are relatively immune from "due process" — that is, from the expensive fights before courts and regulators that afflict the firm attempting a hostile takeover.

The actual value of the efficiencies theoretically ascribable to the M-form method of doing business is at present unclear.[146] In particular, performance and cost-efficiency studies of financial holding company systems are inconclusive in important respects.[147] Efficiencies in raising capital and the merits of dis-

---

[146] Much work that might appear at first glance to be relevant really focuses on other issues. For example, Mason & Goudzwaard, *Performance of Conglomerate Firms: A Portfolio Approach*, 31 J. FINANCE 39 (1976), offers some extremely negative evidence on the performance of conglomerate firms, while Scott, *On the Theory of Conglomerate Mergers*, 32 J. FINANCE 1235 (1977), deftly theorizes about factors which influence whether conglomerates will produce benefits. But two points should be noted. First, many *non*conglomerate firms are organized in the M-form way. Williamson's theory should be confirmed or rejected by proper comparisons between M-form firms and U-form firms, and not necessarily between conglomerate organizations and nonconglomerate firms. Second, the studies referred to define conglomerates in terms of growth by acquisition, as opposed to internal growth; given this meaning, some companies with diverse, unrelated lines of business would not be considered conglomerates. But the method of growth does not seem relevant to whether the supposed benefits of M-form organization will obtain.

[147] Unfortunately for my purposes, most studies of bank holding company (BHC) *performance* bear on multi-BHC's. Some results: (1) Multi-BHC's affect the asset structure of acquired banks; BHC banks hold less cash and United States government securities, more state and municipal bonds, and more loans per dollar of assets than independent banks. That is, their assets are riskier but they provide more service to their communities. (2) Multi-BHC banks are more leveraged than comparable independent banks. It is not known whether diversification gains offset the greater risk of failure which is presumed (not known) to accompany this extra leverage. (3) BHC banks have higher earnings *and* expenses after affiliation; their profitability remains relatively unchanged. (4) BHC banks do not grow faster than other banks. In contrast to these clear findings, there are only three studies on the impact of BHC's on performance of nonbank affiliates, and for various methodological reasons they must be regarded as inconclusive. *See* Curry, *The Performance of Bank Holding Companies: A Review of the Literature*, in Federal Reserve Staff Compendium, *supra* note 130, § 4. For a more recent study, finding that both multi-BHC banks and one-BHC banks are more profitable than their non-BHC counterparts, *see* Mullineaux, *Economies of Scale*

posing of excess capacity appear to have been taken for granted rather than rigorously studied.[148] But the theoretical arguments for believing such efficiencies exist in significant amounts seem fairly persuasive, and this should make one chary of prohibiting or severely restricting financial holding company systems.[149]

2. *Ambiguous Reasons for Holding Company Formation.* — (*a*) *Overcoming Restrictions on Lines of Business.* — Management may form a holding company in order to overcome limitations on the activities in which the financial intermediary can engage. This motivation is strongest in the case of insurance companies, which may become part of holding company systems that have affiliates engaged in virtually any line of business.[150] The incentive is less for bank managements, since affiliates of banks generally must be engaged in businesses "so closely related to banking or managing or controlling banks as to be a proper incident thereto," [151] and many in fact carry on businesses in which banks themselves could engage. Nevertheless, the incentive exists. It also motivates managers of some savings and loan associations, the non-S & L subsidiaries of which may engage in related activities (in the case of multiple-association holding companies) or in virtually any activities (in the case of single-association holding companies).

That managements seek by the holding company device to avoid activity limitations on financial intermediaries is not, by

---

and Organizational Efficiencies in Banking: A Profit-Function Approach, 33 J. FINANCE 259, 278 (1978).

Again, there is only fragmentary evidence on *efficiency* and the existence of scale economies in *nonbanking* activities of BHC's. The more sophisticated empirical work on cost efficiency in banking is rather favorable to multi-BHC's, however. Burke, *Bank Holding Company Affiliation and Cost Efficiency*, in Federal Reserve Staff Compendium, *supra* note 130, § 5.

I know of no good evidence on insurance holding companies. But there are some sad tales than can be told. *See Diversification Haunts the Insurance Industry*, BUS. WEEK, Aug. 24, 1974, at 52; *But the Other Side* Wasn't *Greener*, FORBES, Sept. 1, 1975, at 78.

[148] Once an intermediary or an affiliate is performing a service for the intermediary business, it may make very good sense indeed to sell excess capacity. But the key question is whether, even assuming such sales, it would have been better for the intermediary to have purchased the service from an independent provider.

[149] This discussion assumes that a significant number of financial holding companies can and do operate as M-form organizations. Rose, *Bank Holding Companies as Operational Single Entities: A Review*, in Federal Reserve Staff Compendium, *supra* note 130, § 3, finds that BHC's probably tend to operate their systems as integrated entities rather than separate operations, but a close reading of his account of the types of control usually exerted by the top management reveals that most are consistent with the controls imposed by Williamson's M-form managers.

[150] *See* pp. 807–10 *supra*.

[151] 12 U.S.C. § 1843(c)(8) (1976). *See also* p. 820 *supra*.

itself, cause for alarm or regulation. After all, the intermediary business may still be kept separate and sound. The *mere presence* of separately incorporated, nonintermediary affiliates need not frustrate even the goal of administrative efficiency in regulation to promote the intermediary's soundness. If the intermediary and its affiliate have nothing to do with one another, such regulation need not be especially complex. Of course, once a holding company system has been formed to overcome restraints on lines of business, management may take further actions — such as depletion of the intermediary's assets in order to support the affiliates, or unfair transactions between the intermediary and its affiliates — that endanger the intermediary or the goals behind regulating it. But the possibility of those further actions is a separate issue and is therefore examined separately.[152] On the other hand, while the desire to overcome legal restraints on lines of business may often occur in a context where management believes that there are superior, nonintermediary business opportunities that for tax reasons cannot feasibly be pursued by shareholders using dividend income received from the intermediary, this need not be the reason for such a desire. Therefore, the mere fact that a holding company was formed in order to avoid restraints on lines of business cannot be taken, by itself, as evidence that the formation was socially desirable.

(*b*) *Diversification.* — Management may form a holding company system in order to diversify risks.[153] Because diversification of risk is a social good, this reason for forming holding companies seems to argue against strict regulation — assuming that such diversification does occur. There are a few studies providing limited evidence that bank holding company expansion into new activities may reduce the overall risk exposure of the holding company organization and yield diversification benefits.[154] And one may argue that there are diversification benefits

---

[152] *See* pp. 829–34 *infra* (self-dealing and confusion of identities).

[153] Risk is "diversified" when the investor's resources are put into capital assets or businesses whose earning streams covary negatively, or not too positively, so that a smoothing, or reduction in volatility, of overall earnings results. This specific usage must be distinguished from the use of "diversification" to describe the process of branching out into new lines of business, which may or may not result in a diversification of risk.

[154] Eisemann, *Diversification and the Congeneric Bank Holding Company*, 7 J. BANK RESEARCH 68 (1976); Heggestad, *Riskiness of Investments in Nonbank Activities by Bank Holding Companies*, 27 J. ECON. & BUS. 219 (1975); M. JESSEE & S. SEELIG, BANK HOLDING COMPANIES AND THE PUBLIC INTEREST: AN ECONOMIC ANALYSIS 77–132 (1977); Johnson & Meinster, *Bank Holding Companies: Diversification Opportunities in Nonbank Activities*, 1 E. ECON. J. 318 (1974). These studies, and others relating to bank or bank holding company soundness, are discussed in Rose, *The Effect of the Bank Holding Company Movement on Bank*

resulting from the amalgamation of *banking* subsidiaries in diverse localities,[155] as well as diversification benefits in the insurance holding company systems.[156] Moreover, if the "closely related" and "reasonably ancillary" tests were abolished, one would expect diversification benefits to be greater than they now are, since businesses with earnings that are more likely to covary negatively could be combined.

But the deeper problem is that conglomeration is a rough and inefficient way of achieving diversification benefits. Financial analysts have argued that the investor can obtain fairly complete diversification at low cost by investing varying amounts of money in stocks and bonds of different companies: though a traditional investment company or index fund may help smaller investors to diversify, no special diversification benefits can be gained by a holding company management's putting together a small part of the investor's potential portfolio in fixed proportions.[157] Thus the possibility that holding companies generate diversification benefits does not argue very strongly against regulation.

(*c*) *Enhancing Management's Status.* — Holding company systems may also enhance the power, status, and personal income of an intermediary's management, at least to the extent that these are a function of the size and diversity of the corporate operations that it controls.[158] Thus, a power-motivated management may wish to retain corporate earnings; if the intermediary has few

---

Safety and Soundness: A Literature Review, in Federal Reserve Staff Compendium, *supra* note 130, § 6, at 14–17.

[155] There seem to be no empirical studies on the geographical diversification aspects of multibank holding company expansion. Rose, *supra* note 154, at 31.

[156] Wolke, *supra* note 88, at 98; Kemper, *supra* note 138, at 326.

[157] *See, e.g.*, Levy & Sarnat, *Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers*, 25 J. FINANCE 795 (1970); Mason & Goudzwaard, *supra* note 146; Smith & Schreiner, *A Portfolio Analysis of Conglomerate Diversification*, 24 J. FINANCE 416 (1969). The argument that conglomerate acquisitions do not produce special diversification benefits does not, however, exhaust the question whether there might be a "pure financial" rationale for conglomerate mergers.

[158] There is evidence of correlations among some of these variables. For example, a study by Towers, Perrin, Forster & Crosby, executive compensation specialists, showed that in 1976 differences in sales volume accounted for about 40% of the differences in executive pay. For the chief executive officer (CEO), the other factors found to be important in determining why one CEO was paid more than another were the total number of employees in the company, the return on equity, whether the CEO was eligible to receive a bonus, and the length of time he held his position. Crystal, *The Battle for Executive Pay*, N.Y. Times, June 19, 1977, § 6 (Financial), at 11, col. 1. *But see* W. MCEACHERN, MANAGERIAL CONTROL AND PERFORMANCE 25–30 (1975) (review of empirical work on relationship between executive compensation and firm performance; results inconsistent, with later work indicating that firms do not pay executives primarily for sales maximization).

good investment opportunities, however, retention of earnings might appear to be a breach of management's fiduciary duty to maximize shareholder wealth. Retention of earnings in a more freewheeling holding company system, rather than in the intermediary, preserves management's power while allowing it to maintain that such activities make good business sense for the holding company's shareholders.

The danger in this process is that management may retain earnings for expansion when that is not in the shareholders' best interest.[159] This danger, however, is always present in management-controlled companies, most of which are free to engage directly in almost any line of business. There is no good reason to think either that the problem is more severe in financial holding companies or that it calls for special regulation of such holding companies.

(*d*) *Multiplying the Benefits of Limited Liability.* — Management may form a holding company system simply to multiply the benefits of the limited liability attaching to the corporate form. Since the creditors of each separate corporation generally have no access to the assets of other companies in the system, management may wish to place different assets in related but distinct corporate entities, thereby limiting creditors' remedies while conducting essentially the same business operations. Whether this process is socially desirable is not really known, but there are good reasons to assume that in most cases there are no deleterious economic consequences.[160] Furthermore, if taking advantage of limited liability is thought to be unfair to some types of creditors, such as trade creditors and tort victims, the problem is a quite general one. For example, nonintermediary holding companies, and companies that are not part of holding company systems but are thinly capitalized, are prey to the same objection. Thus, in the absence of specific reasons to think otherwise, this problem, if it exists, calls for a general remedy — several are available[161] — not for special regulation of financial holding companies.

[159] For evidence that the danger is real, see O. WILLIAMSON, THE ECONOMICS OF DISCRETIONARY BEHAVIOR: MANAGERIAL OBJECTIVES IN A THEORY OF THE FIRM 134–39 (1967).

[160] *See generally* Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976). Basically, the most important creditors simply set the terms of their loans in light of the fact of limited liability. If they take more risk because of the legal rule, they demand more compensation. The main economic effect of limited liability is a good one: it lowers transaction costs by preventing corporate creditors from bringing a series of individual collection suits against the numerous, scattered shareholders of publicly held corporations that have defaulted on their loans.

[161] A legislature might require that corporations maintain their net worth at a specified, substantial level, or that they obtain a certain amount of liability insur-

3. *Negative Reasons for Holding Company Formation.* — (*a*) *Antitrust Considerations.* — Financial holding company systems, as well as other conglomerates, may be formed to accomplish or facilitate anticompetitive practices, such as tie-ins, reciprocal dealing, predatory pricing, and the elimination of potential competition. These practices have been extensively analyzed in the antitrust literature. Many expert commentators think that the dangers posed by these practices are often overstated or that for other reasons harsh legal rules about them are not in order.[162] For example, even the moderate commentators believe that only under rather special conditions will a tie-in enable a monopolist to increase his profits beyond what they would be if he exercised his monopoly power in a straightforward way.[163] Nevertheless, because there is nothing positively good about tie-ins, and because they may lead a buyer to choose a seller on a basis other than competitive considerations, they are, at least nominally, per se illegal.[164] But under current doctrine a plaintiff still has to prove that the defendant had some monopoly power in the tying product, and that the tying arrangements foreclosed a substantial volume of sales or leases in the tied product market; these conditions are simply not satisfied in the case of many alleged or apparent tying arrangements.[165] Rational predatory pricing also has fairly severe prerequisites.[166] Similarly, the conditions under which a conglomerate acquisition will actually cause a meaningful

---

ance; sophisticated contract creditors could be automatically subordinated in bankruptcy; or mandatory first-party compensation schemes, such as no-fault insurance, could be enacted. Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 551–52 n.123 (1977).

162 The following references gloss over some sharp disagreements among these commentators, but they do support my general observation in the text:

On tying arrangements, see 3 P. AREEDA & D. TURNER, *supra* note 22, ¶ 733; R. POSNER, ANTITRUST LAW 182 (1976); R. BORK, THE ANTITRUST PARADOX 380–81 (1978).

On reciprocal buying, see F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 280–82 (1970); R. BORK, *supra*, at 257–59, 380–81.

On predatory pricing, see F. SCHERER, *supra*, at 484; R. POSNER, *supra*, at 185–89; Areeda & Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975); 3 P. AREEDA & D. TURNER, *supra* note 22, ¶ 711(a); R. BORK, *supra*, at 144–45, 250–55.

On potential competition, see P. AREEDA & D. TURNER, *supra* note 22, ¶ 701(c); R. BORK, *supra*, at 259–60; R. POSNER, *supra*, at 122–24.

163 *See* 3 P. AREEDA & D. TURNER, *supra* note 22, ¶ 733.

164 Standard Oil v. United States, 337 U.S. 293, 305–06 (1949); International Salt Co. v. United States, 332 U.S. 392, 396 (1947).

165 Admittedly, these requirements have been attenuated in actual cases. *See, e.g.*, Northern Pac. Ry. v. United States, 356 U.S. 1 (1958); International Salt Co. v. United States, 332 U.S. 392 (1947). But this tendency has little to recommend it.

166 *See* P. AREEDA & D. TURNER, *supra* note 22, ¶ 711(b).

elimination of potential competition are rather stringent, and the idea of potential competition therefore seems to have been overworked by antitrust plaintiffs — a possibility that appears to have been well appreciated by the Supreme Court in its more recent opinions on the subject.[167] The law against these practices does exist, of course, and they may indeed cause harm to competition. The point of putting them into perspective is to support the proposition that effective safeguards against such dangers can be established without flatly prohibiting conglomerates or conglomerate acquisitions. Case-by-case policing under developed — or reformed — antitrust doctrines seems quite adequate.

The chief additional question in the present context is whether there is substantial reason for believing that ordinary antitrust law and policies will be significantly less adequate for financial holding company systems than they are for other conglomerate systems. One abstract argument, which does not withstand scrutiny, is that so many different types of persons and businesses want one major financial-intermediary service — loans of money — that opportunities for tie-ins and reciprocal dealings will be more pervasive in financial holding company systems than in ordinary conglomerates. Ties between credit and related services, such as credit life insurance, were indeed a major fear expressed in hearings leading to passage of the Bank Holding Company Amendments of 1970,[168] and the law expressly forbids such tie-ins.[169] But experience under the law suggests that the issue was not a problem.[170] In retrospect, this is not surprising; the capital

[167] *E.g.*, United States v. Marine Bancorporation, Inc., 418 U.S. 602 (1974).

[168] Pub. L. No. 91-607, 84 Stat. 1760 (codified at 12 U.S.C. §§ 1841-1843, 1849-1850 (1976)). Throughout the hearings, almost every witness who supported the bill noted the significance of the tie-in problem, and almost every opponent was questioned as to his knowledge of that significance. *See Bank Holding Company Act Amendments: Hearings on H.R. 6778 Before the House Comm. on Banking and Currency*, pts. 1-2, 91st Cong., 1st Sess. (1969) [hereinafter cited as *1969 House Hearings*]. The exaggerated nature of the fear is shown by the expressed belief that the most threatening aspect of the tie-in problem was that its effect could occur without any affirmative action on the part of the credit-extending bank: borrowers might buy from the banks' affiliates simply to ensure a friendly banking relationship. *See id.* at 91, 93 (remarks of Asst. Atty. Gen. McLaren).

Before passage of the 1956 Act, ch. 240, 70 Stat. 133 (current version at 12 U.S.C. §§ 1841-1850 (1976)), similar fears were voiced. *See, e.g.*, *Control of Bank Holding Companies: Hearings on S. 880, S. 2350, and H.R. 6227 Before the Subcomm. on Banking of the Senate Comm. on Banking and Currency*, 84th Cong., 1st Sess. 64-66 (1955).

[169] 12 U.S.C. § 1972 (1976).

[170] The annotations under 12 U.S.C.A. § 1972 (West Supp. 1978) (prohibitions against tying arrangements) list only two cases, Clark v. United Bank, 480 F.2d 235 (10th Cir.), *cert. denied*, 414 U.S. 1004 (1973); Swerdloff v. Miami Nat'l Bank, 408 F. Supp. 940 (S.D. Fla. 1976), both of which were unsuccessful and

markets of this country are among its most efficient and competitive, and the idea that significant monopoly power in the provision of credit is more than a spotty phenomenon limited to certain submarkets is not very plausible.[171] There is no good evidence known to this author to suggest that harmful reciprocal-dealing problems have been substantial, much less exceptionally severe, in financial conglomerates.

As for predatory pricing, cries have been raised by some independent suppliers of data-processing services that bank holding companies which supply such services to themselves sell their excess capacity below cost, meaning below the independents' and perhaps the holding companies' average cost. One would expect the holding companies to be willing to sell excess capacity at marginal cost if necessary. But there seems to be little serious documentation concerning bank holding company sales *below* marginal cost (shortrun or longrun), and something like this is what ought to be shown to prove objectionable predatory pricing. Finally, the Supreme Court has persuasively rebuffed government efforts to apply the potential competition doctrine to bank holding company acquisitions.[172]

In short, the case for going beyond regular antitrust law in dealing with possible anticompetitive practices of financial holding companies has not been proven.

(*b*) *Facilitating Fraud, Unfair Self-Dealing, and Excessive*

---

actually involved a bank's request for collateral security (a compensating balance in one case, a transfer of stock in the other) for a loan. Federal Reserve Staff Compendium, *supra* note 130, which constitutes a nearly encyclopedic survey of literature on the observed merits and demerits of bank holding companies, virtually ignores tie-ins. *See also* Edwards, *Tie-In Sales in Banking and One Bank Holding Companies*, 14 ANTITRUST BULL. 587 (1969).

On the other hand, there is strong evidence that credit extensions by banks and products or services of bank affiliates are in fact sold together on a widespread basis. *Competition in Banking Act of 1976: Hearings on S. 2721 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. 99–104 (1976) (references to investigations by Sutherland, Asbill, and Brennan); *id.* at 61–68 (app. 7 to statement of Edward J. Kremer; reference to FTC study). This evidence suggests tie-ins but does not show that they have serious anticompetitive effects or, indeed, that many of the linked sales are illegal under current law.

[171] One also doubts whether many would-be exploiters of their market power in credit extensions could foreclose a *substantial part* of the business in the tied-product market, *e.g.*, credit life insurance. Such foreclosure ought to be a prerequisite for illegality.

[172] *See* note 167 *supra*. Since the text focuses on bank holding companies, it may be useful to note the existence of literature on the allegedly special antitrust problems caused by insurance holding companies. *See, e.g.*, Kammerschen, *Are Conglomerate Insurance Mergers Sui Generis?*, 41 J. RISK & INS. 463 (1974); Zimmerman, *Antitrust and the Insurance Holding Company*, in 1969 ABA INSURANCE, NEGLIGENCE & COMPENSATION SECTION 329.

Dividends. — A financial holding company may facilitate fraud and self-dealing. The managers, or whoever else simultaneously controls the "decisions" of both entities in a self-dealing situation, will bias transactions toward the subsidiary in which they have the greatest direct or indirect interest. In financial holding company systems, situations can readily arise in which the bias is against the subsidiaries that are financial intermediaries. Since they tend to be much larger than other subsidiaries, it is more costly to acquire complete ownership of their voting stock, and less important to do so in order to gain working control. The promoters of an acquisition-oriented holding company may therefore find it more convenient to obtain a smaller interest in intermediaries than in other subsidiaries.[173]

Fear of bias in intercompany transactions has in fact evoked special concern for the soundness of financial intermediaries in holding company systems. Thus, in hearings connected with the federal Bank Holding Company Act there were references to the danger that holding company banks would make unsound loans to their affiliates.[174] Subsidiary banks could also be milked by purchasing services or property at inflated prices from other affiliates. This type of abuse received less attention and less regulation, possibly because it is much easier to bankrupt a bank by subverting its principal activity — making loans — than by forcing unfair purchases of services and incidental property items. This situation is regrettable, in a way, because unfairness in transactions involving property and services is probably harder to monitor and prove than unfairness in loans.

Another danger is that management will cause the inter-

---

[173] Even equal ownership of intermediaries and other subsidiaries does not preclude self-dealing. A holding company might want its intermediary subsidiary to be overcharged in its dealings with an equally owned affiliate because management believes that overstating sales and profits of the affiliate might attract new business to the affiliate and thus benefit the holding company. Or an intermediary could be defrauded to the benefit of an affiliate, even though identical percentages of the stock of both entities were held by the holding company, because the relevant *managers'* compensation was tied more closely to reported performance of the affiliate. This could happen, for example, if a subgroup of the system's management had stock appreciation rights geared to the affiliate and were in a position to control the terms of the transaction between the intermediary and the affiliate (as by supplying false information to other, disinterested managers in the system).

[174] *See, e.g., 1969 House Hearings, supra* note 168, at 2 (statement of Chairman Patman); *Control and Regulation of Bank Holding Companies: Hearings on H.R. 2674 Before the House Comm. on Banking and Currency*, 84th Cong., 1st Sess. 212 (1955) (statement of D. Emmert Brumbaugh). *See also* STAFF OF THE HOUSE COMM. ON BANKING AND CURRENCY, 91ST CONG., 1ST SESS., REPORT: THE GROWTH OF UNREGISTERED BANK HOLDING COMPANIES — PROBLEMS AND PROSPECTS 2 (Comm. Print 1969).

mediary to pay excessive dividends in order to finance the holding company's other ventures. Whether it acts with intent to strip the intermediary or merely out of zeal for promoting the other ventures, the result is the same: dividends, although more in the open than is unfairness in self-dealing transactions, always involve a lack of current consideration flowing from the recipient to the company paying the dividend. From the point of view of the company's creditors, such as depositors or policyholders, all dividends are paid without fair consideration (since the company receives no leviable assets), and, if they leave the company insolvent or possessed of unreasonably small capital, they may be attacked as fraudulent conveyances or as illegal dividends under a corporate or regulatory statute. Short of this extreme, large dividends may leave the intermediary more highly leveraged and thus more risky and less able to support new business. Unless regulated by strict and administrable standards, therefore, dividends can be most dangerous to a financial intermediary. Recent empirical work showing that holding company banks have lower capital ratios [175] than independent banks arguably gives reason to be concerned. There is also evidence that some insurance holding companies have extracted excessive dividends from their insurance subsidiaries.[176]

Fears of unsound loans, unfairness in other transactions, and excessive dividends were also displayed in the principal periods of uproar involving insurance holding companies [177] and savings

---

[175] *See* Rose, *supra* note 154, at 23–25, and sources cited therein.

[176] A primary reason for the formation of insurance holding companies (IHC's) and the acquisition of insurance companies in the late 1960's was precisely to get at and use the apparently excessive funds of insurers in other businesses. In August 1967, the brokerage firm of Carter, Berlind & Weill, Inc. produced a report entitled *The Financial Service Holding Company* (the Netter Report). It disclosed that many fire and casualty companies possessed surplus far in excess of what state regulation required, explained that a debt-heavy conglomerate could transfer the redundant liquid assets of an insurance subsidiary to itself, and urged the making of takeover bids for various insurance companies. Clients responded to the urging. STAFF OF ANTITRUST SUBCOMM. OF HOUSE COMM. ON THE JUDICIARY, 92D CONG., 1ST SESS., INVESTIGATION OF CONGLOMERATE CORPORATIONS 216–20, 243–56 (Comm. Print 1971); J. WINSLOW, CONGLOMERATES UNLIMITED: THE FAILURE OF REGULATION 81 (1973). *See also The Billion-Dollar Insurance Caper*, FORBES, Oct. 15, 1970, at 66; *Regulators Eye Insurance Funds*, BUS. WEEK, Jan. 2, 1971, at 36. Many of the upstream payments were substantial. Continental Corporation extracted $286 million from its insurance subsidiary, while INA Corporation received $270 million in 1969 alone. *The Milkers Get Milked*, FORBES, Feb. 15, 1975, at 55. National General Corporation caused Great American Insurance Corporation to pay a "dividend" of $171 million. *Great American Insurance Votes Special Dividend*, Wall St. J., Jan. 29, 1969, at 2, col. 2.

[177] *See, e.g.*, State of New York Insurance Dep't, *supra* note 74, at 32–33. Even before the rise of insurance holding companies became widespread, regulators

and loan holding companies.[178] In every case, they were major ostensible reasons for enacting regulation. In addition, the opposite face of unfair treatment of the intermediary, namely, the favored treatment of the nonintermediary affiliate, provoked a tremendous amount of concern among the competitors of these affiliates. A diverse spectrum of groups and trade associations, ranging from finance companies and insurance salesmen to travel agents, protested bitterly about the "anticompetitive practices" that might result from the unregulated growth of financial conglomerates.[179] But distinguishing harm to competitors that results from inequitably favorable treatment of intermediary affiliates from harm to them that results from the financial holding company's superior efficiency is extremely difficult. In any event one must substantially discount the protestations voiced by competitors of entities sought to be regulated.[180]

Self-dealing transactions can, of course, afflict any corporation.

---

noted their involvement in a substantial percentage of insolvencies. *See* H. JOSEPHSON, LIFE INSURANCE AND THE PUBLIC INTEREST 54 (1971).

The study of two specific cases will give the interested reader a sense of the enormity of the self-dealing and abuse of insurance subsidiaries that have sometimes occurred. The first involved National General Corporation's control of Great American Insurance Company. The chilling story is chronicled in a series of newspaper accounts. *Insurance Dividend Spurs State Inquiry*, N.Y. Times, Jan. 31, 1969, at 53, col. 7; *Insurance Mergers Questioned: Hart Sees Trouble, id.*, Mar. 6, 1969, at 57, col. 2; *National General Insurance Firm Slapped With Record Fine Over Securities Dealings*, Wall St. J., Dec. 4, 1969, at 4, col. 2; *National General Sued Along With Officers by Stockholder in Unit, id.*, Dec. 16, 1970, at 10, col. 2; *American Financial Unit Settles Suit Against It, Sets $4 Million Debt Issue, id.*, Mar. 1, 1974, at 19, col. 1; *National General Says IRS Seeks $22 Million in Added Tax From It, id.*, Apr. 10, 1973, at 22, col. 3. The second good example of holding company fraud involved Standard Life and Accident Company, the largest insurance company in Oklahoma. Again the documentation is scattered. *A Scandal Shakes Standard Life's Empire*, BUS. WEEK, Feb. 3, 1975, at 48; *Standard Life Expects Gulf South Corporation Unit to Default on Debts*, Wall St. J., Mar. 25, 1974, at 12, col. 3; *Standard Life Trading Is Suspended by SEC, id.*, Apr. 29, 1974, at 8, col. 4; *Standard Life and Gulf South Mortgage Are Charged With Fraud in SEC Action, id.*, Jan. 22, 1975, at 12, col. 1; *American National Is Told to Take Over a Standard Life Unit, id.*, Feb. 2, 1976, at 1, col. 6.

178 *See, e.g.*, T. MARVELL, *supra* note 120, at 199–216.

179 For evidence in the case reports of competitors' attacks on attempted expansions of the powers of banks and bank holding companies, *see, e.g.*, M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377 (9th Cir. 1977), *cert. denied*, 98 S. Ct. 3069 (1978); Alabama Ass'n of Independent Ins. Agents v. Board of Governors of the Fed. Reserve Sys., 533 F.2d 224 (5th Cir. 1976), *on second petition for rehearing*, 558 F.2d 729 (1977), *cert. denied*, 435 U.S. 904 (1978); Arnold Tours, Inc. v. Camp, 472 F.2d 427 (1st Cir. 1972).

180 Apparently, some courts do just that. *See* Case Comment, *The Permissibility of Leasing Under the National Bank Act*, 91 HARV. L. REV. 1347, 1355 (1978) (court neglects unfair competition argument).

But holding company systems magnify the danger: they complicate the situation and make monitoring and detection of misconduct more costly and difficult. For example, autopsies of the public utility holding company systems of the 1920's strongly suggest that the industry's byzantine holding company structures served not only to achieve extreme leverage and control by a few persons who contributed a miniscule amount of the system's capital, but also to facilitate and hide the draining of the core business's revenues via charges by affiliated "service" corporations and in other ways.[181] Thus, the holding company systems were not only pyramids but also smokescreens. Unraveling the intercompany dealings proved to be enormously difficult in retrospect; one infers that the outside investors' knowledge of these dealings before the great debacles was far less than that required for reasonably efficient markets.

A point related to the smokescreen function of holding company systems is that they can be the setting for the externalization of functions that were or could be performed directly by the business that requires them. Perhaps the best examples are the investment-type financial intermediaries, such as mutual funds, many of which belong to groups of related entities. These groups are not financial holding company systems in a narrow sense, because those who control the systems do not own much stock in the intermediaries, but they are similar to such systems because the controlling persons have practical control over the intermediaries, as well as dominant stock ownership in the affiliates.[182] Many registered investment companies, for example, are externally managed and marketed: a separate advisory company gives the advice and makes the decisions concerning the investment portfolio, and it or an affiliate does the wholesaling of shares in the investment company itself. The sponsors and promoters of the fund generally control these servicing companies, and the arrangement appears to result in higher total compensation to the promoters than do systems in which the functions are internalized in the investment company.[183]

Externalization of functions is also rampant in the real estate investment trust industry, a fact which has created significant agitation about alleged excessive fees and some regulatory re-

---

[181] *See* Blair-Smith & Helfenstein, *A Death Sentence or a New Lease on Life? A Survey of Corporate Adjustments Under the Public Utility Holding Company Act*, 94 U. PA. L. REV. 148, 150–51 (1946).

[182] On mutual fund structure and the phenomenon of externalization of management, see SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H. REP. No. 2337, 89th Cong., 2d Sess. 45–59 (1966).

[183] *See id.* at 49 (discussion of Massachusetts Investors Trust).

sponses.[184] By contrast, most management and marketing of bank services have been done by banks themselves, and there has been little or no movement toward regulation of the salaries and compensation of the bank employees performing these functions. The insurance industry presents another variation, also consistent with the thesis that externalization facilitates abuse. Management of the loan and investment decisions is generally internalized, and few have called for limits to the compensation of insurance company personnel who perform these functions; but sales are often the work of independent agents who may receive large sales commissions, and the states have thought it necessary to subject agents and their sales practices to special regulation.[185]

In summary, an incentive for unfair self-dealing is present whenever controlling persons have different interests in different parts of a holding company system. Because holding company systems can serve as smokescreens or as ways of externalizing services, the dangers of fraud and unfair self-dealing in such systems can be great. In addition, there is a danger that holding companies will extract excessive dividends from some of their subsidiaries. In financial holding companies, these dangers tend to fall on the intermediary subsidiary and thus threaten the dominant goal of insuring the soundness of intermediaries. This is the major real problem posed by financial holding companies. It should be the focus of regulation.

4. Generally Unintended Consequences. — *(a) Confused Identities and Veil-Piercing.* — The most interesting category of unintended dangers is increased risks to the intermediary business posed by the holding company form. One alleged danger, heavily emphasized by Schotland in the aftermath of the mid-1970's troubles of bank-sponsored real estate investment trusts,[186] is that the public may confuse the name and identity of a risky affiliate with that of the intermediary itself, with the result that a loss of confidence in the risky business, due perhaps to some business calamity, will be transferred to the intermediary. In the case of banks, this may lead to a devastating run on deposits; with insurance companies, a slowing of new business or even a widespread failure of policyholders to continue paying premiums.

---

[184] *E.g.*, Statement of Policy Adopted by Midwest Securities Commissioners Association on July 16, 1970, and by North American Securities Administrators Association, Inc. on Sept. 24, 1970, 1 BLUE SKY L. REP. (CCH) ¶ 4801 (Mar. 19, 1971) (recommending specific limitations on aggregate annual fees and expenses of REIT's). *See also* Greenspun v. Bogan, 492 F.2d 375 (1st Cir. 1974).

[185] *See generally* D. MCGILL, LIFE INSURANCE 772–74 (rev. ed. 1967); Freeman, *Marketing Mutual Funds and Individual Life Insurance*, 28 S.C.L. REV. 1, 48 (1976).

[186] Schotland, *supra* note 36, at 270–77.

These chains of events have in fact occurred,[187] though one can dispute how serious the danger is.

Another source of concern is that creditors of a bankrupt affiliate may be able to pierce the corporate veil and get at the assets of the intermediary, with priority over the latter's public suppliers of capital or their surrogate, a deposit insurance or insurance guarantee fund.[188] This is a purely speculative danger. Not only is there no evidence that this kind of veil-piercing has ever occurred to a nontrivial degree, but in the normal case, where abuse is of the intermediary, one would expect veil-piercing in the opposite direction: by a failed intermediary's creditors, to the assets of its parent company and affiliates. Furthermore, both existing legal doctrine about fraudulent conveyances and veil-piercing and an appreciation of the weight legal policy gives to protection of depositors and policyholders indicate that an affiliate's creditors will rarely be given priority over, or even parity with, the intermediary's public creditors; it is shareholders or knowing creditors of the holding company who will be held unlimitedly liable, subordinated, or the like.[189]

(*b*) *Suboptimal Management.* — It is also said that holding company systems attract "wilder" and risk-loving managers.[190] Both the proposition and its implications are problematic. If financial holding companies were forbidden altogether, it seems unlikely that the starry-eyed expansionists would keep out of the management of financial intermediaries. In addition, any evidence that holding company managers are more risk loving *and* that this characteristic per se causes increased risks to intermediary subsidiaries that are financial intermediaries is anecdotal at best.[191] Absent better evidence, this supposed danger should be disregarded or assumed to manifest itself in other phenomena, such as excessive dividends from the intermediary subsidiary, that can be independently evaluated and controlled.

Similarly unconvincing is the assertion that holding company systems divert the expertise of the intermediary's managers into

---

[187] *Id.* On the insurance side, an example is provided by the Equity Funding scandal, which led to a widespread slowdown in premiums paid to an affiliate not directly injured by the wrongdoers.

[188] Black, Miller & Posner, *An Approach to the Regulation of Bank Holding Companies*, 51 J. Bus. 379, 395–98 (1978). The authors conclude, however, that the practical extent of the danger may not be great.

[189] *Cf.* Clark, *supra* note 161, at 540–53 (discussion of relationship between veil-piercing and fraudulent conveyances or other objectionable conduct).

[190] *See* Schotland, *supra* note 36, at 256; *cf.* Kemper, *supra* note 138, at 327 (young personnel versus traditionally stodgy, old-fashioned insurance industry).

[191] As to the sources cited note 190, for example, it is not clear that the new young managers were either dangerously risk loving or in a position to influence major holding company policies.

other areas. The implication seems to be that the managers should be forced to stick to the grindstone of straight financial intermediary activities, which they know. But, even if the danger of diversion were taken seriously and holding company systems were totally forbidden, it is hard to believe that diversion, perhaps in less socially desirable forms, could be eliminated: one doubts that stick-to-itness can be legislated.

Another argument is that an intermediary's managers often lack expertise in the areas into which their newly formed holding company systems contemplate going and therefore run a high risk of failure.[192] This argument is inconsistent with competitors' cries to limit or forbid financial holding company expansion into numerous financial activities. It is also counterintuitive with respect to many financial activities, where one presumes that many skills are indeed transferable. Moreover, there seems to be no good systematic evidence of the extent to which affiliated businesses are in fact staffed by the intermediary's former personnel or of the correlation between this pattern and failure of the affiliated nonintermediary business. In any event, these factual uncertainties are largely irrelevant to policy: if the intermediary business is kept safe, failure in the affiliated lines of business should be the worry of shareholders, not legislators. There is no generally recognized public policy of ensuring that nonintermediary businesses be kept safe.

(*c*) Zaibatsu[193] *Risks.* — Another category of unintended dangers posed by financial holding companies has to do with risk, not to intermediary soundness, but to the economy or polity generally. One example is the fear that the systems will lead to undue concentration in some lines of business. As argued in connection with specific anticompetitive practices,[194] this kind of problem seems susceptible of treatment by normal antitrust policies and techniques. Another instance is the fear, occasionally surfacing with great vigor, that permitting holding company expansion may lead to financial conglomerates whose great size and power are *by themselves* anathema to the American ethos.[195] Nevertheless,

---

[192] *See, e.g.*, *The Billion Dollar Insurance Caper*, *supra* note 176, at 68.

[193] The Japanese term *zaibatsu* is used to describe the large financial and industrial conglomerates which ruled the Japanese economy. The term was used in the hearings preceding passage of the Bank Holding Company Act Amendments of 1970 to express fears about the direction in which the United States economy seemed to some persons to be moving. *See* Note, *Regulating the One-Bank Holding Companies — Precluding Zaibatsu?*, 46 ST. JOHN'S L. REV. 320 (1971).

[194] *See* pp. 826–28 *supra*; pp. 836–38 *infra*.

[195] *See, e.g.*, *1969 House Hearings*, *supra* note 168, at 9–11 (statement of A.A. Berle); 115 CONG. REC. 32, 893–902 (1969) (remarks by Rep. Patman); *One Bank Holding Company Legislation of 1970: Hearings on S. 1052, S. 1221, S. 1664, S.*

one can believe, on the basis of history, experience, and political theory, that great concentration of power is extremely unwise, no matter what its economic efficiency while unabused, and yet not be worried — currently — about the expansion of financial holding companies into unrelated fields. The United States is far from being a *zaibatsu* system.[196]

C. Alternative to Outlawing Holding Companies

To summarize the results of the discussion in the preceding section, financial holding companies pose four principal dangers. They may facilitate anticompetitive practices. Or they may pose three distinct threats to the soundness of intermediaries: holding companies may lead to confusion of the identities of subsidiaries, facilitate fraud and harmful self-dealing, and increase the risk that excessive dividends will be paid by the intermediary. But financial conglomerates offer positive advantages as well. They ameliorate the effects of certain unwise regulatory restraints, they can be used to avoid a choice between excess taxes and suboptimal investment decisions, and they may produce organizational efficiencies. Thus it would be unwise simply to outlaw financial holding companies — that is, to express the separation theme in nearly absolute terms. Rather, one must deal with each danger separately, while taking care to ensure that the legal responses to each problem are consistent with one another.

1. Anticompetitive Effects. — The antitrust concerns raised by financial holding companies are similar to those raised by other holding companies and conglomerates; they endanger primarily the customers of the system rather than the intermediary subsidiaries. As the previous discussion pointed out, a need for stricter antitrust standards in this area has not been demonstrated. Nor has any good justification for looser standards been offered. Weak-

3823, and H.R. 6778 Before the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. at 47–48, 57–60, 167–68 (1970) (statements of Charles E. Walker, Undersecretary of the Treasury, and Frank Wille, Chairman of FDIC); Zimmerman, *supra* note 172, at 329, 339–40.

[196] The evidence on the impact of bank holding company expansion indicates that bank holding companies have not significantly increased their control over aggregate financial resources in the economy as a whole; have not significantly affected competition in commercial banking at either the national, state, or local levels; and do not dominate the leasing or finance industries, though they are important holders of mortgage banking firms. Glassman & Eisenbeis, *Bank Holding Companies and Concentration of Banking and Financial Resources: A Review*, in Federal Reserve Staff Compendium, *supra* note 130, § 8, at 25–27; *cf.* Rhoades, *The Effect of Bank Holding Companies on Competition: A Review of the Evidence*, in *id.* § 7, at 18 (research indicates that BHC's have had little if any effect on competition in banking and nonbanking markets).

ening competitive forces is neither a necessary nor a desirable way of promoting the soundness goal. No one has shown why, when financial intermediaries are involved, so-called public benefits, such as making new services available in a town, should weigh either more or less heavily in the balance against possible anticompetitive effects than they do in ordinary antitrust reasoning.

As for antitrust procedures, it would appear that the best way of ensuring that ordinary antitrust rules and policies are applied to financial conglomerates is to let antitrust review of their actions be handled, as it ordinarily would be, by the Antitrust Division of the Department of Justice. Intermediary regulators, by virtue of their specialized focus, have a special slant on their regulated industries. They naturally tend to be solicitous of the general needs and problems of their industries and therefore incline toward anticompetitive regulation. Because they have made market intervention a habit, they may lack the ability to refrain from action, an ability that is often essential to the promotion of competition. And because they place greatest value on soundness, the spirit of competition may be absent from their hearts, or may grow there in a distorted shape. Even if this is not so, they may function better if they specialize in their main job, insuring soundness. Moreover, there has been a demonstrable, serious lack of uniformity in the ways that different intermediary regulators have applied the same antitrust standards.[197] Today, after passage of the Antitrust Improvements Act of 1976,[198] most large business combinations are subject to prior review, and the procedures of that Act should suffice for financial intermediaries. In sum, there seems to be no defensible reason for not treating financial holding company acquisitions and practices under regular antitrust standards and regular antitrust procedures.

This conclusion is essentially negative, but quite important. Without good reason, current statutory law either dilutes antitrust standards for intermediary mergers and financial holding company acquisitions or at least presents the risk that these standards will be lost in the shuffling of nebulous other factors. Moreover, it subjects the antitrust merits of these transactions to review by the agencies that specialize in regulating intermediaries

[197] *See, e.g.*, Kintner & Hansen, *A Review of the Law of Bank Mergers*, 14 B.C. IND. & COM. L. REV. 213, 249–50 (1972) (Fed and FDIC, but not Comptroller, have moved toward same interpretation of antitrust standards as is applied by courts); Robertson, *Federal Regulation of Banking: A Plea for Unification*, 31 LAW & CONTEMP. PROB. 673, 688 (1966).

[198] 15 U.S.C. § 18a (1976). Of course, under the statute as presently written, mergers and holding company acquisitions involving banks and S & L's are exempt. *Id.* § 18a(c)(7)–(8).

primarily for other reasons and that are consequently not oriented toward antitrust review.

2. Confusion of Identities. — The problems of identity confusion could be solved simply by forbidding financial holding companies or their nonintermediary subsidiaries to use names substantially similar to those of their intermediary affiliates. Using similar names, of course, can produce some real benefits. Bank *X* and its affiliated finance company *Y*, for example, might both be managed by the same group, which has been extremely successful and has a long tradition of excellence. This connection is of rational interest to customers and investors, and allowing the system to advertise it would be likely to improve the decisions of investors and customers, but using similar names is hardly the only way to publicize the relationship. Advertising could simply spell out the facts: *Y* is affiliated with a well-known and respected bank, *X*, and both companies are ultimately managed by the same group of individuals. This may be cumbersome advertising, but it would be less ambiguous than a name similarity. It would convey the relevant information, but in a form that would virtually ensure that the investor or customer will not confuse the intermediary with its affiliates. This effect could be reinforced by a disclosure requirement that advertisements of the sort indicated must contain a prominently displayed statement that the intermediary is not liable for any obligations of the affiliate and that its assets and resources are not available for use by the affiliate.

3. Self-Dealing. — Given the special concern for the soundness of financial intermediaries, the historical fact that fraud and self-dealing have been the major threats to their soundness,[199]

[199] Clark, *supra* note 4, at 12 n.46:

According to an FDIC analysis of the 80 insured bank failures between January 1, 1960 and December 31, 1975, the basic causes of failures were as follows: in 42 cases (52.5%) improper loans to officers, directors, or owners, coupled in some cases with loans to out-of-territory borrowers or misuse of brokered funds; in 24 cases (30%) defalcation, embezzlement, or manipulation; in 14 cases (17.5%) managerial weaknesses in loan portfolio and general asset management. Letter to author from C.F. Muckenfuss III, Special Assistant to the Director, FDIC (Mar. 4, 1976) . . . . Failed banks tend to be relatively small though recent events certainly show that this is not a universal rule. *Id.*

McKinsey & Company, Inc. analyzed the 230 insurance company insolvencies (101 life companies and 129 property-liability companies) that occurred between 1963 and 1972. Among life companies, the main cause of insolvencies was dishonest management (77% of the cases). The primary cause of property-liability insolvencies was underwriting losses (59% of cases) — as one might expect, given the risky nature of such insurance. But dishonest management and dishonest or bankrupt agents or reinsurers were substantial factors, being the primary causes in 34% and 6% of the cases, respectively. McKinsey & Company, Inc., Final Report to National Association of Insurance Commissioners, Strengthening the Surveillance System 3-1 to 3-3 (Apr. 1974). Other studies of insurance company insolvencies are cited in Epton & Bixby, *Insurance Guaranty Funds: A Reassessment*, 25 DEPAUL L. REV. 227, 227 n.2 (1976).

and the usefulness of the holding company form to facilitate self-dealing, the law should impose stricter regulations on intercompany dealing within financial holding company systems than on transactions between ordinary business corporations and their directors, officers, and affiliates. At the same time, regulation that unduly hinders efforts to take advantage of efficiencies related to conglomerate organization should be avoided.

One approach would be to try to uproot the major incentive to self-deal by regulating the structure of financial holding company systems. A statute would prohibit financial holding companies from owning greater percentages of stock in nonintermediary subsidiaries than in intermediary subsidiaries, and thereby curb the tendency to favor the former in intercompany transactions.[200] But such a rule would be less than ideal. It would impose seemingly needless costs if it forced holding companies to buy greater interests in intermediary subsidiaries even when no interaffiliate dealings, much less unfair ones, were contemplated.[201] It might multiply occasions in which nonintermediary subsidiaries are abused. It would leave things open for favoritism to one intermediary subsidiary at the expense of another — a problem not solved by percentage-of-ownership regulation unless one adopts the extreme expedient of mandating exactly equal ownership of all intermediary subsidiaries. And it would not be completely effective, since there is a multiplicity of reasons for favoritism besides stock ownership differences. Even in holding company systems in which all subsidiaries are wholly owned, conflict of interest problems are not absent.[202]

Another remedial approach, the one urged here, would be simply to prohibit all transactions among affiliates of a financial holding company system, with limited exceptions. The major

---

[200] A milder version of this policy was suggested in State of New York Insurance Dep't, *supra* note 74, at 18.

[201] One is reminded of the debate concerning Professor Andrews' proposed "equal opportunity" rule concerning the sale of controlling blocks of stock; critics thought it would have the practical effect of forcing purchasers to buy virtually all stock of target companies and that this result would be unfair. *Compare* Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965), *with* Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHI. L. REV. 420 (1965).

[202] It should be remembered that, because public creditors of banks, thrift institutions, and insurance companies are protected by fixed-premium deposit insurance and insurance guaranty schemes, managers attuned to stockholder welfare are subject to an important "moral hazard": they have an incentive to increase the risk borne by the intermediary's public creditors, since neither the managers nor the stockholders have to bear the costs of extra riskiness (via higher deposit insurance premiums, or by way of higher interest payments to depositors or "dividends" to policyholders). One way of responding to the incentive is to shortchange the intermediary in intrasystem dealings. *See also* note 173 *supra*.

exceptions are that dividends from subsidiaries to parents would be regulated rather than prohibited, and capital contributions by parents to subsidiaries would be allowed. Obviously, no company could be expected to run a subsidiary business that yielded it no returns, or to refrain from financing new opportunities presented to its subsidiaries. Other exceptions, based on demonstrable efficiencies from intercompany dealing that are not duplicable in a market, would require administrative approval.[203]

This approach is rooted in several considerations: abusive self-dealing in financial holding company systems is a serious problem, and properly administered prophylactic rules would reduce its severity; externalization of service functions, another significant problem, would also be reduced by such rules; and the system would promote administrative economy. To the prediction that prohibitory rules would reduce unfair self-dealing, it might be objected that some holding company systems would violate the flat prohibitions against intercompany dealings, and this prospect would necessitate its own monitoring and enforcement costs. But these should not be nearly as large as the parallel costs in a system that did not prohibit intercompany transactions but simply required that they be found to be fair, if and when attacked in the courts. One reason is that flat prohibitions would probably deter many unfair transactions that would otherwise have been carried out by managers able to persuade themselves and their peers, in view of factual complexities and multiple considerations, that the deals were not clearly unfair. It is harder to rationalize a violation of a flat prohibition than of a fairness rule. In addition, detecting and proving a violation of a flat prohibition should be a much easier, that is, cheaper, task for the regulators. Consequently, the probability that violators would be detected and made to endure a sanction will increase. Moreover, since deterrence is presumably a function of the size of the sanction and the probability of its being applied, the flat rule should exert greater deterrent force on managerial behavior than would a fairness rule.

Another advantage of a strict regulatory rule is that it could easily be administered so as to prevent managers from externalizing service functions that could just as well be kept within the intermediary. Limiting affiliate-directed transfers of wealth from the intermediary subsidiaries primarily to dividends would simplify the task of regulators, since they could focus on establishing and enforcing good rules concerning dividends. Confining out-

[203] A system of administrative approval need not create nightmares. *See* pp. 842–44 *infra*.

flows to one spigot should make it easier to monitor and control them.

An administrative exemption procedure would be a corollary to the one-spigot approach, for some self-dealing transactions may have positive virtues or efficiencies. Self-dealing, here defined neutrally to mean a transaction in which a person has power to influence the decisions of both bargaining entities but a greater interest in how well one of them fares, may produce a net advantage or "surplus" over what could be achieved in any comparable, feasible transaction between independent parties. Though many variations of the idea can be formulated, virtually all conceivable instances of self-dealing surplus fall into one of two categories. One category is transactional savings: self-dealing may reduce search, information, and coordination costs. Consider an insurance company *X* and its data processing affiliate of long standing, *Y*. By virtue of the actions necessarily involved in having financed and maintained a holding company system, *X* and *Y* and their parent company will have consumed valuable resources in gaining intimate knowledge about the operations, capabilities, and relative strengths and weaknesses of one another. Much of the information may be "impacted": though present in the understandings of the various managers and operating in a more or less instinctive manner in their factual judgments and decisions, it is not available in convenient, articulated, verified form to the world outside, and it would be costly or impossible to put it in such form. An independent data processing firm *Z* bidding to get the insurance company's business will face greater uncertainty than the affiliate in preparing a price estimate, since it will feel more uncertain about the exact demands of the company, the quality of its personnel, the degree of cooperation and facilitation they could supply, and so forth. Consequently, it would have to expend a certain amount of wealth, *w*, in order to achieve the level of certainty that the affiliate already has. But for the independent firm *Z*, expenditure *w* is a prospective cost and must therefore enter into its price estimate and its decision whether to deal with *X*. For *Y*, expenditures on "establishing a relationship" are sunk costs and therefore irrelevant to current decisionmaking. Moreover, from the point of view of social efficiency, it is clearly more desirable, other things being equal, to have *Y* rather than *Z* supply the services. The problem, of course, is that other things are not equal: there is greater danger of unfair self-dealing if *Y* supplies the services, and in the imperfect real world *Y* and *Z* may differ significantly in the quality and cost of their services. Thus, the apparent surplus may not be a real net surplus, though this fact may be extraordinarily difficulty to discover.

A second kind of self-dealing surplus arises when the affiliate is the best supplier to the intermediary. More precisely, even apart from transaction cost savings that holding company systems may regularly tend to generate, the affiliate may occasionally have some degree of monopoly power, some unique advantage — whether by virtue of location, regulation, better technology, or other cause of competitive advantage — that makes dealing with it a better thing for the intermediary (and society) than dealing with an independent firm. How significant these situations are is anyone's guess; one expects that they are less frequent, but individually more significant, than situations involving transaction cost savings.

The practical response to these two possible kinds of savings is to require that the intermediary and its affiliate, when seeking an administrative exemption from strict rules against self-dealing, show, affirmatively and by a preponderance of the evidence, that a self-dealing surplus will result from the proposed transaction, and that the intermediary will share in it.[204] This recommendation is stricter than the prevailing rule of "fairness" governing self-interested transactions between general business corporations and their directors,[205] without the complications of supposedly strict systems for controlling conflicts of interest such as that of the Employee Retirement Income Security Act of 1974.[206] It amounts to a "more than fair" rule for exemptions. The argument for going beyond fairness is both simple and persuasive: as long as self-dealing poses any significant danger that an affected corporation will be abused, there is no reason to permit it unless it allows a distinct *improvement* over feasible arms' length dealings in the market place. In the case of intercompany dealings in a financial holding company system, the possibility that undetected unfairness will be visited upon one of the related transacting entities — typically, a financial intermediary — is quite commonly present because detection of unfairness is intrinsically difficult.[207]

---

[204] More specific rules as to what would constitute adequate "proof" of a self-dealing surplus might be adopted by the agency.

[205] *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (1975) (fairness test).

[206] 29 U.S.C. § 1108(a) (1976) (variances from prohibited-transaction rules granted when "in the interests of the plan and of its participants and beneficiaries"). This test might be construed to be satisfied by any fair self-dealing transaction that makes sense to the pension plan or only by a more than fair transaction, *i.e.*, one the benefits of which cannot be duplicated in an other-dealing transaction.

[207] There is no need to assert that detection of unfairness is uniquely difficult in the case of *financial* holding company systems. Indeed, I am quite willing to generalize my analysis and recommendations to cover self-dealing involving *all* publicly held corporations, and have done so in a chapter of a forthcoming book. But there is reason for believing that self-dealing is more pervasive in financial intermediaries and therefore, even if self-dealing rules applicable to corporations

For instance, even when an affiliate is selling a service to an intermediary at what appears to be the going market price, one may legitimately raise questions about the quality of the service, as compared to that available from independent firms, or about the optimal amount of service needed by the intermediary; unfortunately, it may be quite difficult and costly to answer these questions in an unambiguous way. Even where transactions involve assets such as real estate valued by an "independent" appraiser, it is often difficult to prove or disprove the "true" market price. Even sales of marketable securities at market prices may be difficult for a monitoring shareholder or regulator to evaluate properly, for whether the intermediary will benefit from selling or buying the security depends on the other securities that are in its portfolio, its liquidity needs, and its other current opportunities.[208] When a transaction is not *in fact* an arms' length deal in a reasonably competitive market, there is often no easy way to judge its fairness. Thus, if a substitute arms' length deal is available, the outside shareholders and public creditors of the intermediary gain nothing by passing it up in return for taking this risk of hidden and uncorrected unfairness. Consequently, the applicants for an exemption should have to show that the proposed transaction is significantly better than fair to the intermediary.

While various objections can be raised against the idea of an administrative exemption scheme, many can be handled by proper design of the system. Procedural rules should be drafted so as to ensure prompt processing of requests, avoid involvement by more than one agency, and make clear to the applicant both what information it must supply and what standard it must meet.[209] The governing statute should permit the agency, by rulemaking in accordance with specified procedures and standards, to grant blanket exemptions to clearly described classes of transactions. The statute itself might give blanket treatment to small transactions, since the cost of obtaining an exemption would be large in relation to the amounts of possible benefits and dangers. Another objection goes more to the heart of the administrative exemption proposal: it is arguably cheaper, and permits quicker approvals of proposed transactions, to allow outside directors

---

generally are not to be upgraded, a higher rule is more clearly justified in this context.

[208] On the importance of liquidity needs or, more generally, the suitability or true value to an investor of a given investment asset, see Clark, *supra* note 4, at 53-57. *See also* Moffitt, *One Group That Should Not Buy Any Stocks, A New Theory Suggests, Is the Stockbrokers*, Wall St. J., June 26, 1978, at 28, col. 1.

[209] The procedural problems to be avoided, and a proposed solution, are discussed in Note, *At Variance with the Administrative Exemption Procedures of ERISA: A Proposed Reform*, 87 YALE L.J. 760, 772-74, 776, 781-82 (1978).

rather than regulators to make "more than fair" findings about self-dealing transactions, record their deliberations, and stand ready to endure liability if later shown to have judged dishonestly or carelessly. At present, however, it is unrealistic to suppose that outside directors are really independent in most of the corporations and holding company systems that badly need independent outsiders, and in any event it would be difficult to prove that a director's decision to bless a transaction later shown to be unfair was dishonestly motivated or carelessly made rather than simply mistaken.[210]

A more general question about any strict system of prohibitory rules and exemption procedures is whether it is consistent with acceptance of the idea that financial holding companies may achieve organizational efficiencies,[211] for the possibility of their doing so counsels against regulation that would stifle these efficiencies. Nothing recommended here would stifle the holding company's ability to reap economies of scale in capital raising. Nor would the proposed system of regulation deprive financial conglomerates of the supposed benefits identified by Williamson as flowing from the M-form method of organizing and running businesses. Those benefits derive principally from top management's ability to monitor objectively the performance of the various divisions or affiliated subsidiaries and to respond to performance differences, in a cheaper and more refined way than the capital markets could, by adjusting the budgets of the units. This they can do despite the proposed strict system of self-dealing rules, for, apart from the rather limited restraints on intermediary dividends discussed in the next subsection, they will be free to draw dividends from some subsidiaries and make capital contributions to the more promising ones. Indeed, forbidding intersubsidiary dealings reinforces the M-form model because it is precisely the device of treating different divisions as separate profit centers that is supposed to give the M-form organization an edge over the older U-form organization.

The other possible efficiencies of a multiunit enterprise are those that obtain just because the units do business with one another under favorable circumstances — efficiencies that might be called the coordination and uncertainty-reducing benefits of vertical integration, in the case of a single corporation, or self-dealing surplus, in the case of a holding company system. The proposed

---

[210] Of course, courts can inquire into "independent" directors' decisions approving transactions between the corporation and a manager and may discount an approval if they find it careless or tainted by fraud. But it is very difficult for them to get below superficial indicators of diligence or to uncover tacit collusion.

[211] *See* pp. 819–22 *supra*.

regulatory scheme would attempt to preserve these benefits by allowing management to obtain administrative approval of the transactions and arrangements generating them. Admittedly, some sacrifice of these benefits would be involved, for managements would not seek approval whenever the costs of the procedure exceeded the expected benefits. This is the price to be paid for a reduction in abusive self-dealing and its threat to soundness. It must be noted, however, that by internalizing functions, many, perhaps most, forms of self-dealing surplus could readily be converted into vertical integration benefits, especially if needless restrictions on intermediaries, such as most bank branching rules, were repealed. Thus converted, management would not be affected at all by the self-dealing rules and could reap these benefits to the fullest extent. For example, a company that performs data processing services for its affiliated life insurance company could simply be merged into the insurer; it would continue to provide the services to the insurance division proper and might even sell excess capacity to unrelated parties. Since, as a legal matter, the assets and profits of the data processing division would belong to the corporation as a whole, the intermediary's regulators would care little whether any interdivisional pricing was fair, or whether vertical integration benefits really existed. And management, thinking the interdivisional activities to be good ones, would never be deterred by the costs of an exemption procedure. Put another way, in many such cases it would be better for everyone, except insiders seeking to augment their personal profits,[212] to internalize "closely related" or "ancillary" activities in the intermediary itself.

4. Excessive Dividends. — The risk that an intermediary will be made to pay excessive dividends is really part of the more general problem of preventing inadequate net worth in intermediaries that are parts of holding company systems. Inadequate net worth could be caused by other means, such as deliberate failure to make new positive contributions to the capital of a growing intermediary subsidiary. And while excessive dividends and inadequate net worth appear to be more common in holding company systems, they can occur in any intermediary regardless of whether it belongs to a holding company system. Because the problem is not confined to holding company intermediaries, its solution should not be so confined.

Like the recommendations concerning antitrust dangers, this point is negative but important. Banking and insurance regulators currently do not have clear, continuing power to make effective

---

[212] *See* pp. 832–33 *supra* for discussion of the role that externalization plays in facilitating abuses.

regulations about "capital ratios" and "surplus" levels; much of their de facto power is exerted only when the intermediary or its parent or another affiliate needs formal approval under vague criteria for some transaction, such as a holding company acquisition, that is only weakly related to capitalization problems.

The best strategy for dealing with the danger of inadequate net worth is a vast subject considered elsewhere,[213] but a few additional thoughts should be offered here. Large dividends could be regulated in two ways. They could be simply prohibited whenever they would leave the intermediary with net worth below a minimum amount established by regulation as adequate. Or they could be "taxed" in the amount of the additional costs they create — the losses which would result from failure of the intermediary multiplied by the additional probability of failure caused by excessive dividends. The tax would be in the form of an increase in the premiums the intermediary must pay to its deposit insurance or insurance guaranty fund.[214]

The first technique is an inflexible, all-or-nothing one. Moreover, historical evidence suggests the need for a truly dramatic increase in net worth over past and present levels before there is a significant impact on an intermediary's probability of failure.[215] One might suppose that simply mandating very high capital adequacy or surplus requirements for banks and insurance companies would be very costly, given the tax advantages[216] of debt financing. While recent scholarship has argued that even great increases in bank capital adequacy ratios are relatively inexpen-

---

[213] On the banking side, see, *e.g.*, G. VOJTA, BANK CAPITAL ADEQUACY (1973); Scott & Mayer, *Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform*, 23 STAN. L. REV. 857, 886–95 (1971); Summers, *Bank Capital Adequacy: Perspectives and Prospects*, FED. RESERVE BANK RICHMOND, ECON. REV., July–Aug. 1977, at 3; Taggart, *Regulatory Influences on Bank Capital*, FED. RESERVE BANK BOSTON, NEW ENGLAND ECON. REV., Sept.–Oct. 1977, at 37. On the insurance company side, see, *e.g.*, D. ANDERSON, AN ANALYSIS OF THE EFFECTS OF UNDERVALUATIONS AND OVERVALUATIONS IN LOSS RESERVES RELATIVE TO THOSE OF UNDERWRITING RESULTS AND VARIABLE ASSET VALUES UPON POLICYHOLDERS' SURPLUS (1973); Finkelstein, *The Use of Risk Theory in Framing Solvency Controls for Nonlife Insurance Companies*, 119 U. PA. L. REV. 730 (1971); Hofflander, *Minimum Capital and Surplus Requirements for Multiple Line Insurance Companies: A New Approach*, in INSURANCE, GOVERNMENT AND SOCIAL POLICY 69 (S. Kimball & H. Denenberg eds. 1969).

[214] On the prevalence and functions of such schemes, see Clark, *supra* note 4, at 86–90.

[215] *See id.* at 63 (actual variations in bank capital ratios and banks not shown to have been material factor in determining bank failures). In other words, as far as empirical evidence is concerned, it may take a *very* large increase in bank capital ratios to affect the rate of bank failures in a noticeable way.

[216] Interest payments to debtholders are deductible by a corporation, I.R.C. § 163; dividend payments to shareholders are not.

sive,[217] this argument fails to consider the crucial relevance of factors such as the tax brackets of the individual shareholders.[218] The costs of increased capital adequacy ratios must still be considered very uncertain.[219]

An alternative approach is to let the deposit insurance funds vary their premiums to reflect the increased riskiness, if any, posed by banks in financial holding companies.[220] I would not,

---

[217] Black, Miller & Posner, *supra* note 188, at 388–89, 402–03. This argument is premised upon the well-known Modigliani and Miller (M-M) theorem, *see* Modigliani & Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958), which asserts that the total cost of capital of a firm does not depend on its ratio of debt to equity.

[218] A common objection to the M-M position, *see* note 217 *supra*, is that, although it applies in a tax-free world, the financing decision is nevertheless distorted by tax considerations. Part of Black, Miller, and Posner's response is to say that the tax advantage of singly taxed interest payments on debt, as contrasted with doubly taxed dividend payments on stock, may be compensated for by the technique of retention of corporate earnings coupled with the sale of stock at capital gains tax rates. By itself, this response would be incomplete. Retention of earnings can provide savings to stockholders, but whether there are savings in comparison to their position if they were debt holders sharing in a similar pretax corporate income, and what the savings are, depend very much on their tax brackets, *see* Clark, *supra* note 143, at 102 nn.43 & 45, 110 n.81, and numerous other factors (such as the availability or unavailability of profitable uses for the retained earnings and the fact that the retentive strategy is potentially susceptible to managerial abuse, *see, e.g.*, Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919), which may create negative values that must be taken into account. Consequently, if capital means equity capital, it is not at all clear, absent possession of a good deal of basic data about bank earnings, the ownership of bank stock, and bank stockholder tax characteristics, whether and how often imposing a very high capital adequacy requirement would create greater burdens for the elite suppliers of capital to banks (*i.e.*, bank stockholders, *see* Clark, *supra* note 4, at 11). These same arguments could be made with respect to insurance companies, but they would have less force because of the low effective tax rates on many insurance companies. *See generally* Clark, *The Federal Income Taxation of Financial Intermediaries*, 84 YALE L.J. 1603, 1637–75 (1975).

[219] This uncertainty is made even more important by the evidence that increasing safety by restricting intermediary leveraging would require a tremendous restraint on leveraging; if prohibiting leverage has its costs they may well be large costs.

A solution to these problems may be to deem debentures, subordinated to the claims of the public suppliers of capital, to be capital for the purpose of satisfying capital adequacy requirements. *See* Black, Miller & Posner, *supra* note 188, at 389. Such debentures could be issued by intermediaries to financing persons who prefer debt to equity. Nevertheless, this technique is hardly perfect. The subordinated debentures would serve as a cushion to the interests of public creditors, but they would increase the risk that the intermediary would undergo insolvency proceedings and incur the associated transaction costs. And if one were to mitigate this risk by attenuating the debenture holders' rights to demand payment and collect their claims, one would aggravate the risk that the Internal Revenue Service would reclassify the debentures as equity for tax purposes.

[220] *Id.* at 406–07. The authors' most preferred alternative, however, seems to

however, allow regulators to presume increased riskiness from the mere fact of membership in a holding company system, *if* my proposals regarding identity confusion and intercompany dealing were adopted. The premiums should vary with a number of financial measures and other indicators of bank soundness, some of which would be affected automatically by a large dividend. I would also extend the strategy to insurance holding companies and savings and loan companies, since their suppliers of capital are generally protected by governmentally sponsored insurance schemes that could be modified to provide for variable premiums.[221]

5. A Pervasive Problem. — Cutting across the four categories of problems already discussed are additional difficulties: bad reasons for holding company regulation, and rules and procedures that serve socially unwise objectives. When attempting to devise improvements in the law, one must ferret out special interest provisions that do not contribute to the general public interest.

There are at least three prominent categories of such provisions. First, holding company regulation may be a form of antitakeover statute geared to protecting incumbent managers of financial intermediaries. As noted earlier,[222] for example, the model law about insurance holding companies bears this objective on its face. A second objectionable reason for financial holding company regulation is the expansion of the jurisdiction — and hence the status and welfare — of regulatory agencies. Again, the history of the insurance holding company movement provides evidence of the real force of this objective.[223] Of course, the motivations that cause regulators to state beliefs and urge causes of action are, strictly speaking, not logically relevant to assessing the truth of the beliefs or the validity of the public-interest arguments put forward for the proposed course of action. But uncovering a self-interested motivation for the making of an argument does, as a practical matter, suggest that very close scrutiny of the argument will expose an error.

A third improper objective of financial holding company regulation is the goal of protecting the actual or potential competitors of the companies and their affiliates from competition. Again, one must not confuse discovery of motivation with discovery of

be to do nothing at all about the allegedly greater riskiness stemming from holding company affiliations, since they are not persuaded that any greater risk has been demonstrated. *Id.* at 399–400.

[221] *See* Clark, *supra* note 4, at 86–90.

[222] *See* note 84 *supra*.

[223] *See* Barger, *The Insurance Holding Company: The Aftermath — Living with the Legislation*, 1970 ABA INSURANCE, NEGLIGENCE & COMPENSATION SECTION 185, 187.

a flaw in argument, but it may be that some aspects of regulation can realistically be understood as serving no purpose other than the protection of some firms from competition.

III. Evaluation of Current Law

Current law is justified in expressing the separation theme by imposing severe limits on the nature of the activities of financial intermediaries themselves. It is probably right in not paying much attention to restrictions on managerial overlaps as a mode of separation regulation. As for the other two ways of expressing the separation theme — limiting holding company activities and limiting transactions between holding company affiliates — the emphasis of the current law is skewed. The clearest contrast to the regulatory approach recommended here is that of the Bank Holding Company Act. That statute strictly limits the lines of business of the financial intermediary's affiliates, but only indirectly and incompletely regulates interaffiliate transactions.[224] In my view, this emphasis is precisely backwards: the statute is strict where there is no clear reason for not being liberal, and lax where there are good reasons, rooted in history and human nature, for being severe. The chief danger of the regulatory scheme is that it may not solve adequately the major problem of financial holding company systems, the abuse of the financial intermediaries for the benefit of other interests in the systems. The fact that the law needlessly prevents possible conglomerate efficiencies is a lesser defect, given the facts that sizable M-form efficiencies might be realized in a holding company system containing only financial intermediaries as members and that other business ventures can always be conducted within other kinds of conglomerate organizations.

If it were customary to attribute a legislative state of mind as well as a legislative intention to a statute, the attribution in this case would reflect the statute's origin in a period of heightened merger activity. The statute's "closely related" test expresses a nebulous, free-floating anxiety about size and financial conglomeration per se, rather than a focused concern about the specific ways in which financial conglomerates actually threaten the public interest or the soundness of financial intermediaries. The exaggerated antitrust concerns[225] may have destroyed the sobriety

[224] *See* pp. 796–98, 802–03 *supra*.

[225] It is ironic that the Act arguably weakened antitrust tests by putting them into a balancing test. Trying to express antitrust concerns by imposing activity limits is an odd business, perhaps intelligible only to the competitors of bank holding companies.

needed to obtain a precise awareness of the dangers of self-dealing.

A more sympathetic interpretation of the legislative frame of mind behind the Bank Holding Company Act would stress that the fundamental legislative decision was to outlaw financial conglomerates. On the one hand, the legislators could then perceive no definite positive values stemming from bank holding companies, other than vertical integration-type or "congeneric" efficiencies. On the other hand, they were presented with a wide array of real and imaginary fears: the *zaibatsu* image, the arguments about tie-ins, dangers to banks, imprudent and disastrous expansion by empire builders, and so forth. Their instinctive response was simply to outlaw conglomerate bank holding companies. The permission to have affiliates engaged in closely related activities can be seen as an afterthought, an exception granted in order that efficiencies of the sort arguably present in vertically integrated enterprises would not be squelched. Under this interpretation, the crucial error was simply a failure to realize that if the law is to take the approach of forbidding the conglomeration of banking and other activities, it ought to go all the way and force internalization of closely related activities. Internalization would often permit the efficiencies to be realized but would curtail the dangers of self-dealing.

The Model Insurance Holding Company System Regulatory Act, by contrast, does not adopt the unnecessary expression of the separation theme by restricting affiliates' lines of business. But it also fails to be strict enough with regard to intercompany dealings, for it only requires that transactions be fair, rather than that there be a self-dealing surplus. The special New York restrictions on an insurer's own subsidiaries seem proper, in view of the direct connection between their riskiness and that of the insurer.[226] This limited method of expressing the separation theme through limits on affiliates' activities could sensibly be applied to other financial intermediaries.

The Savings and Loan Holding Company Act, as noted, restricts affiliates' lines of business if a multiple holding company is involved but not if the affiliates are associated with one insured association; this distinction makes little sense. The statute properly takes a hard line on an association's investing in and lending to affiliates. But its approach to sales of goods and services, regulating but not prohibiting them, is questionable. Not only is there no requirement that a self-dealing surplus be shown, but a stricter approach might have had the benficial result of encourag-

---

[226] *See* p. 807 *supra*.

ing internalization of ancillary services in an industry that for many years has been rife with potential conflicts of interest.[227]

IV. The Definitional Problem: A Reassessment

A. The Criteria of Definitional Decisions

The preceding two Parts dealt mainly with two ways of expressing the separation theme: regulation of the activities of an intermediary's affiliates and regulation of transactions with affiliates. Still open, however, is the question of the proper limits on the activities of financial intermediaries themselves. Such limits are another, and perhaps more important, way of expressing the separation theme. If simpler administration of the soundness goal is accepted as the basic reason for confining financial intermediaries to financial-intermediary activities,[228] then finding the definitional boundaries of "banking" and "insurance" becomes a key inquiry.

We should distinguish between the general business activities in which intermediaries engage, using funds obtained from their depositors or policyholders (*e.g.*, investment operations), and the kinds of financial products and services that they provide to those persons or to other customers. For brevity, I will refer to the former as "business activities" and the latter as "financial products" or "financial services." If, as argued elsewhere,[229] the major aim of our legal system's especially intense regulation of financial intermediaries is to protect their public suppliers of capital (roughly, their depositors and policyholders) from the consequences of an intermediary's financial failure, then this goal implies only an abstract limit on the business activities funded by the public creditors' money. It is not the nature of the investments made and of the businesses carried on by the intermediary that matters directly, but the sheer amount of risk posed to the public creditors. If the law forbids depository institutions to trade in real estate (a traditional risky activity), it is because of the perceived difficulty of cheaply and precisely controlling or insuring the risks presented by such activities to depositors, rather than because of a reverence for the traditional "essence" of banking. If the law biases insurance companies toward long term investments and banks toward short term investments, it is because of a perception that to reduce the risk of a company's

[227] *See* Herman, *Conflicts of Interest in the Savings and Loan Industry*, in 2 Study of the Savings and Loan Industry 763 (I. Friend ed. 1969).

[228] *See* pp. 814–16 *supra*.

[229] Clark, *supra* note 4, at 10–26.

failure one must mesh the characteristics of its investments with those of its obligations, rather than because of a belief about what is inherently part of insurance or banking. Indeed, if the legal system were to rely almost exclusively on variable-premium deposit insurance or guarantee funds to protect public creditors, there would be no obvious policy reason to prevent banks and insurance companies from engaging in nonfinancial business activities. In specific cases, of course, there might be practical reasons for prohibitions. For example, gauging the riskiness of many kinds of nonfinancial activities — in order to set premiums — might be harder and more expensive than gauging the riskiness of most investment activities. But the main point to grasp is that policymakers should focus on the risk posed by various business activities and the administrative costs of monitoring and controlling those risks, rather than on the nature of the activities.

When we turn to the proper financial products of intermediaries, we face knottier problems. Consider any new financial product or service proposed by a bank or insurance company that seems to depart from a traditional, core intuition of banking or insurance services. There are really two distinct issues that underlie the legal controversies evident in the statutes and cases. The first issue concerns regulatory method. By what criterion should policymakers decide whether to go beyond the traditional regulatory strategies for banking or insurance in their response to the new product? In most cases, I suggest, the general form of an ideal answer is simple enough: regulatory strategy must shift when an essential, consciously accepted ingredient of the proposed financial product is that it would pose a substantial risk to the customer purchasing it. The change calls for a shift from the traditional strategies, which are aimed at risk reduction, to a system based on full disclosure and strict fiduciary duties — a system such as that embodied in the Investment Company Act.[230] Applying this general thought in a context where various laws and jurisdictional patterns must be taken as given is far from simple, of course; some of these problems will be explored in the next Section.

The second issue concerns prohibitions. By what criterion should policymakers decide whether to forbid the bank or insurance company from offering the proposed product? A rough general answer is that, with some exceptions, the product should be forbidden when it is not being marketed to, or realistically would not be bought by, a truly public class of customers. As discussed elsewhere,[231] the marks of a public class of customers of financial-

[230] Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (1976).
[231] Clark, *supra* note 4, at 11; Clark, *supra* note 218, at 1616–18.

intermediary services (who are capital suppliers of the intermediaries, even though they might not think of themselves in that way) are its numerosity and the modest average wealth of its members compared to the average wealth of shareholders in public corporations. Since soundness regulation is called for only when there is a truly public class of customers, and since the basic reason for the separation theme is to facilitate the administration of soundness regulation, new financial products aimed at relatively elite classes of potential customers generally should not be permitted to financial intermediaries. Exceptions can be based on several considerations. First, a proposed financial product or service for a less-than-public class of customers might be such that it would pose little hindrance to soundness regulation: the amount of activity of the proposed sort would be so small in relation to the intermediary's main activities that regulators could virtually ignore it, it might be an easily isolable activity presenting no conflicts of interest, and so forth. Second, the product or service might be an efficient way of handling the intermediary's excess capacity for producing services necessary or properly ancillary to its regular activities. For example, if an insurance company provides its own data processing services for its traditional operations, which are of optimal size, it may find it desirable to sell some data processing services to outsiders, who would be business firms rather than public customers in my sense. Permitting it to do so is an especially appealing proposition when the law concerning financial holding companies would encourage managers wishing to realize vertical-integration benefits to internalize the ancillary services within the intermediary, in order that they might avoid the costs of obtaining an exemption permitting interaffiliate transactions.

The combined thrust of these two principles is such that some proposed financial products that would call for a different regulatory method would also meet the criterion for flat prohibition. But distinguishing two issues and principles does have practical consequences. In particular, policymakers might justifiably be lenient, when considering changes in statutes or regulations or the proper resolution of litigation, in allowing all financial intermediaries to offer investment vehicles and investment-advisory services to public customers — in other words, products similar to those offered by the investment-type intermediaries. At the same time, they might insist on strict disclosure-type regulation. This point clearly demands elaboration, which is supplied in the next two Sections.

B. Illustration: Are Investment Activities Within the Definition of "Insurance"?

One may appreciate the futility of seeking a "pure" definition of a particular intermediary function without resort to regulatory goals by analyzing a particular problem at length. The issue, abstractly stated, is whether investment activities are intrinsically part of the business of insurance and, if so, whether any particular types of investment activity are to be excluded from the definition. A definitional problem arises because, under the federal McCarran-Ferguson Act,[232] state regulation of the "business of insurance" supersedes federal law; in addition, the federal securities laws contain express exemptions for "insurance contracts"[233] and "insurance companies."[234] If a company's sales of financial products to customers involve something other or more than "insurance," that extraneous element may be regulated by federal law. The problem of whether an interest in the company's investments is such an extraneous element was posed by three important cases dealing with variable annuity plans offered by insurance companies.[235] Because it is simpler to analyze life insurance than annuities, and because variable life insurance plans pose legal problems quite similar to those involved in the three cases just mentioned, let us analyze the activities of life insurance companies.

Insurance obviously has to do with the reduction of risks. One may construct a spectrum of possible life insurance companies, starting with the most primitive form, that display increasing degrees of completeness and sophistication with regard to the particular types of risk they reduce. The spectrum, which corresponds in a rough way with the historical evolution of the life insurance business, shows that investment activity is not logically entailed by insuring activities, but is practically necessary to an extent that increases with each refinement in insurance activities.

The most primitive life insurance company is probably a small mutual benefit association operating on the assessment plan. A few individuals may agree that, if any of them should die within the coming year, the rest will be assessed their pro rata share of the stipulated death benefit. The risk to be reduced is that of a sudden demand for cash on the part of each member's dependents

[232] 15 U.S.C. §§ 1011–1015 (1976).

[233] Securities Act of 1933, § 3(a)(8), 15 U.S.C. § 77c(a)(8) (1976).

[234] Investment Company Act of 1940, §§ 2(a)(17), 3(c)(3), 15 U.S.C. §§ 80a-2(a)(17), -3(c)(3) (1976).

[235] SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959); Prudential Ins. Co. v. SEC, 326 F.2d 383 (3d Cir. 1964).

because of his death. The intriguing thing about the arrangement is that, while it clearly amounts to a plan of life *insurance*, the insurance company — the association — possesses no money for any significant length of time, and thus will carry on no investment activities.[236]

The assessment plan is faulty in a number of ways, which suggest new refinements. First, individual members may be unable or unwilling to meet their assessments. To reduce this risk of policyholder default the company may insist on collecting assessments in advance, *i.e.*, premiums, with the understanding that unused amounts will be returned to the policyholders at the end of the year. It becomes a simple mutual term insurance company, and must now try to predict how many members in the group will die within the coming year. The innovation also leads to the company's having the premium moneys on hand during an indefinite part of the coming year. Conceivably it could invest them rather than hold them idle. But the investments would have to be in very liquid and therefore low-yielding form, since a policyholder could die at any minute. Moreover, since there are few policyholders and the company is collecting premiums for only one year, the total loss from not investing may seem small compared to the risk involved. In any event, the function of reducing the risk of policyholder default is served whether or not the company invests.

Second, even if the company uses the best mortality tables available, there is a substantial likelihood that, because of the small number of members, more members than were predicted would die, and the company will be unable to meet its policy obligations. Among the many ways of reducing this risk of bankruptcy due to normal sampling error, the most direct is simply to increase the size of the pool by obtaining many more policyholders or by reinsuring. The risk can be reduced whether or not the company invests the money it holds. But the large company will obviously have more funds to invest than the small company would; it is more likely to find investment activity feasible and desirable.

Finally, even if the mortality experience of a company's policyholders should match exactly that of the comparable now living general population, it might differ from the mortality experience predicted by the company, since mortality tables are based on experience with past populations. The term insurance

[236] In the author's terminology, the assessment company will not be a full-fledged "financial intermediary," for while it will accomplish an important pooling function — insurance arrangements are a subset of pooling arrangements — it will not serve as a middleman between savers and ultimate investors. *See* note 1 *supra*.

company of the last paragraph may therefore wind up with an underwriting loss if people die sooner than expected, and, if it charged only a best-estimate premium, it will default on some of its obligations. This risk of bankruptcy due to error in mortality tables can be reduced by the company's obtaining "capital," to use the bankers' term, or, to use the insurance industry's jargon, "surplus." Roughly speaking, surplus simply refers to a positive net worth figure on an insurance company's balance sheet.[237] It may be created in several ways. The company may charge a larger premium than the best-estimate premium, promising to return the excess at the end of the term if unnecessary. It may switch from mutual to stock form, getting its surplus from a separate group of persons, the stockholders. If state law permitted, long term capital from nonpolicyholders could also be obtained from bondholders subordinated to the policyholders. Regardless of the source of surplus, the crucial twin points may once again be made: the new refinement reduces the risk in question — surely an insurance function — without logically necessitating that the insurance company engage in investment activity; but the refinement leads to the company's having more money under its control, and it therefore raises the opportunity cost of not investing.

This refined term insurance company still fails to reduce risks of significant interest to those concerned with the fortunes of policyholders. When an insured covers the risk of death by successive purchases of term insurance policies, his yearly premiums will increase sharply with age and, if he has not saved wisely on the side, may eventually become unaffordable. To reduce this risk of the policyholder's being unable to pay for pure insurance protection in later years, level-premium, whole-life insurance policies were invented.[238] The policyholder pays the same premium amount every year; in the earlier years the amount exceeds the cost of simple term insurance in the same face amount for those years, but in later years the amount is less than the price of comparable term insurance. The excess funds, or reserves,[239] collected

[237] The liabilities on the balance sheet are contingent amounts, based on the deaths, and other events calling for payouts (*e.g.*, policy lapses and surrenders), that are predicted to occur during the limited term of the insurance policies. A surplus account, or positive net worth, means that the company has more than enough money to meet the contingent liabilities; it will be safe from insolvency even if the predictions behind the liability amounts were erroneous and the liabilities are larger (unless the amount of the error exceeds even the surplus).

[238] *See* D. McGill, *supra* note 185, at 32–39; R. Mehr & R. Osler, Modern Life Insurance 671 (3d ed. 1961) (whole-life, level-premium insurance for fixed face amount first offered in 1756). To soften the consequences of the risk that elderly policyholders still might be unable to continue paying premiums, nonforfeiture laws were enacted. *Id.* at 674.

[239] Technically, "reserves," or "reserve liabilities," refers to an item on the

in the early years are used to cover later deficiencies in the collected amounts. With this innovation — the legal reserve life insurance company — the amount of funds controlled by the insurance company increases tremendously, as compared to the previous refinements. Once again, investment activity is not inherently necessary to the risk-reducing function which the business innovation serves, but the innovation has the effect of increasing funds available for investment and thus raises the opportunity cost of not investing. Companies therefore do invest.

Theoretically, of course, policyholders could individually put together the equivalent of level-premium, whole-life insurance by buying yearly term insurance policies and simultaneously adding appropriate amounts to an investment in shares of an investment company, which could be gradually liquidated to pay for large term insurance premiums in later years. This procedure obviously would not satisfy those who think that there are good reasons for a more paternalistic approach, and it might sacrifice whatever economies of scale can result from one company's offering the package. But the possibility of the procedure suggests an important characterization of the sophisticated legal reserve life insurance company: it is a firm that combines the function of offering "pure" insurance protection with that of operating an investment company.

This remark brings us, of course, to the issues raised in the variable annuity cases. As noted, state regulation of "the business of insurance" supersedes federal law. If an insurance company's product in fact gives the policyholder an interest in an investment fund, and such an interest is deemed not to be part of the purchased insurance, then the policyholder's interest in the pool of invested assets may constitute a security, the public offering of which must be registered under the Securities Act of 1933 [240] unless a specific exemption is available. More significantly — because of the enormous problems of application and administration that would be caused [241] — the pool of invested assets may be considered an "investment company" which has to be registered under the Investment Company Act of 1940 and subjected to or specially exempted from its elaborate provisions.[242]

---

liabilities side of an insurer's balance sheet. But since the insurer must maintain assets at least equal in value to these contingent liabilities, it is natural to talk loosely of "reserves" as if they were assets. The assets are set aside (or reserved) in the sense that they cannot be withdrawn as dividends.

[240] 15 U.S.C. §§ 77(b)(1), 77e(a) (1976).

[241] *See generally* Blank, Keen, Payne & Miller, *Variable Life Insurance and the Federal Securities Laws*, 60 VA. L. REV. 71 (1974); Jones, *The Variable Annuity and the 1940 Act — An Uncomfortable Combination*, 3 CONN. L. REV. 144 (1970).

[242] 15 U.S.C. § 80a-3(a)(1), (3) to -7(a) (1976).

Consider, then, two cases which *both* seem to involve the question whether investment activity is part of the business of insurance: (1) a traditional legal reserve life insurance or annuity company, which of course invests heavily in securities, both marketable and illiquid, and (2) a variable annuity or variable life insurance company (or a traditional life insurance company that issues some variable annuity or variable life policies as one of many of its activities, but sets up a "separate account" for those special policies [243]), which also invests heavily in securities. It is clear from the opinions [244] and administrative rulings [245] that variable annuities and variable life insurance generally are not protected by the McCarran-Ferguson Act from the application of the federal securities laws. Why is this rule not applied to the whole-life policies and annuity policies issued by traditional legal reserve companies?

Insofar as the existing authorities can be rationalized, it is not because of a view of the relationship of investment in general to the essence of insurance, but because the two cases differ significantly in the *quantity* of investment risk they present to the policyholder. The quantity of risk is in turn affected by several differences between the two plans. The major point to grasp is that, despite infelicitous language in some of the opinions in the *VALIC* case,[246] all of these sorts of differences ought logically to be thought relevant. For instance, the holder of a traditional annuity policy, but not that of the variable annuity policy, is promised payments in a fixed dollar amount. The risks he retains are the risk that the insurance company will default on its obligations because of poor investment performance and the risk of unexpected inflation which will erode the value of his future payments. The holder of the variable annuity policy takes the normal shareholder-type risk of variations and returns even apart from insolvency of the insurer. Moreover, the risk of de-

[243] *See, e.g.*, Prudential Ins. Co. v. SEC, 326 F.2d 383, 384–85 (3d Cir. 1964) (description of Prudential's variable annuity program). The court held that the company's separate investment fund resulting from the sale of variable annuity contracts was a "fund" within the meaning of the Investment Company Act and that the Act was applicable to the fund, despite the Act's exclusion of insurance companies from the definition of investment companies.

[244] SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); Prudential Ins. Co. v. SEC, 326 F.2d 383 (3d Cir. 1964).

[245] *E.g.*, SEC Investment Company Act Release No. 9482, [1976–1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,767 (Oct. 18, 1976) (limited exemptions from Investment Company Act granted for separate accounts funding variable life insurance). *See generally Variable Life Insurance — Recent Developments*, 32 BUS. L. 697 (1977).

[246] SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959).

fault by a company issuing a traditional policy is in fact very low, because of state law's substantive regulation of risks, one example of which is investment restrictions.

Thus, it makes little sense, at least as an initial policy matter, to suggest that the presence or absence of a significant element of fixed return in the policy is *the* crucial factor, as Justice Douglas' opinion in the *VALIC* case seems to suggest,[247] or that mere participation in any amount of risk-taking in equity investments is *the* crucial factor.[248] *VALIC* and similar cases are actually easy, because most of the rough formal indices of risk in that case went together and corresponded to a real, significant difference in the amount of risk borne by policyholders. But possible hybrid factual situations would strain some of the apparent "tests" mentioned by the Justices. For example, imagine a company which issued annuity policies calling for payment in *fixed* dollar amounts, though the amounts were very high in relation to conventional policies calling for the same premiums. The company is permitted by state law to invest in any financial assets whatsoever, and in fact invests in a common stock portfolio with a very high coefficient of market risk. Let us assume that the state has no alternative scheme, such as a statewide guarantee fund, for reducing the risk posed to the policyholders. The regulatory scheme does, however, examine the company to check compliance with recordkeeping and conflict of interest rules; it does regulate the types of contractual provisions that must or may be in policies, and so forth. Quite possibly, the risk posed to these policyholders would be greater than the risk posed by most actual variable annuity plans. Should Justice Douglas' apparent rule be invoked to treat the policies as "insurance" products exempt by virtue of that characterization from the securities laws, solely because of the element of contractually fixed return? On the other hand, imagine a company that issues variable annuity policies but whose separate investment account for those policies is restricted by law to the same extremely conservative investments in which ordinary life insurance companies can invest. Suppose that the actually expected variations in payouts on the policies are quite small. Should the policies be excluded from the insurance category?

These examples suggest that the McCarran-Ferguson Act concept of insurance would be most rationally articulated as follows: insurance products may of course contain an investment element (as history has long suggested), but products of high investment risk will not be considered insurance for purposes of

---

[247] *Id.* at 71.

[248] *See id.* at 79–80 (Brennan, J., concurring).

this Act. As Justice Brennan's concurring opinion in *VALIC* sometimes suggests,[249] the securities laws' full-disclosure approach should be invoked whenever the financial product is sold *primarily* as a vehicle for the self-conscious taking of significant investment risks, whereas the state laws' substantive-regulation approach should prevail when the product is sold primarily as a vehicle for reducing risks posed by contingencies facing the policyholder as such. This distinction does not, of course, solve all the line-drawing problems one can pose, but it does seem to offer a rational basis for approaching problems. It also suggests the singular inappropriateness of thinking that a pure definition of insurance is the key to a solution of the problem.

This interpretation of the McCarran-Ferguson Act does not, of course, tell us whether the states ought to exercise their freedom to permit insurance companies to sell products with a high component of investment risk. The answer to that question depends on whether such products would seriously hinder or complicate soundness regulation.

C. *Comment: Are Investment-Advisory Services Part of "Banking"?*

Under the definitional criteria recommended in Section A, the Glass-Steagall Act's prohibition against banks' engaging in underwriting activities is in principle correct — assuming the accuracy of the legislators' interpretation of events leading to bank failures in the Depression — since it was based on the perceived difficulty of keeping banks sound when they, or affiliates with which they were free to deal, were also engaged in selling securities to elite suppliers of capital. It does not follow, however, that securities firms should be forbidden from being in bank holding company systems governed by a reformed law that would strictly regulate intercompany dealings. And, it also does not follow that the Glass-Steagall Act should be construed to prohibit banks from offering — and promoting, even aggressively — investment-advisory and investment-management services to small investors, that is, to truly public customers. Under our second criterion, invest-

---

[249] *Id.* at 90–91. The importance Justice Brennan seemingly attached to the similarity of variable annuities to claims in *equity* investment trusts and his description of their dissimilarity to traditional annuities as being a difference *in kind* are, however, off the mark. Different legal treatment should turn simply on *quantity* of risk borne by policyholders; the source of the risk is, or should be, irrelevant. Though application of this principle would not have changed the outcome in *VALIC*, it could have important — indeed, radical — ramifications. It might justify, for example, application of the federal securities laws to *traditional* insurance companies which have a significant risk of becoming insolvent because governing state law contains only weak limitations on investments and surplus.

ment services to a truly public class of customers need not be flatly prohibited. Moreover, there are positive reasons for thinking that allowing banks to provide small-account services would be socially desirable. For instance, banks already have many thousands of retail outlets used by ordinary people to conduct their financial affairs, and promoting the use of small-accounts services through these outlets may therefore entail lower marginal costs than other modes of marketing them, such as establishing new brokerage firm outlets. Under our first criterion, the main concern of policymakers should be simply to ensure that the customers are given the protections of full disclosure and strict regulation of potential conflicts of interest that the bank's providing the service might create. This does not mean that the federal securities regulation of investment advisors and broker-dealer firms must be applied, in all of its complex glory, to banks that offer small-account investment services. It does mean that substantially similar protections must be provided.[250]

V. Conclusion

A major reason for limiting the connections between financial-intermediary activities and other activities is simply to facilitate regulation designed to insure the soundness of intermediaries. In the case of financial intermediaries themselves, this policy points toward a prohibition against business activities not within conventional conceptions of financial-intermediary activities, but it does not entail an extreme prohibition. Other business activities, especially ancillary or closely related activities that may produce efficiencies through integration with principal activities, may properly be permitted when the risks they present to the intermediary's public suppliers of capital can be controlled or insured in an efficient and fairly precise way. The law should look favorably upon new financial products or services that intermediaries propose to offer when they are designed to be marketed to a truly public class of customers. If the new products are intended for customers who self-consciously want to take investment risks, regulators should insist on strong disclosure requirements and conflict-of-interest rules, similar in thrust to those of the Investment Company Act.

The separation theme also extends to financial holding company systems. These systems should not be flatly prohibited, be-

[250] It has been argued that, in many respects, substantially similar protections already exist for customers of the major bank-sponsored investment services thus far offered. *See* Note, *supra* note 60, at 1497–503.

cause they may have beneficial consequences and because their proven bad effects do not justify prohibition. The proper regulatory strategy, I have argued, is to regulate strictly dealings between intermediaries and their affiliates, but not to limit the nature of the business activities in which the affiliates may engage. This view rests upon conclusions about what are and are not the major problems created by the holding company systems. Activity restraints on the affiliates of financial intermediaries seem generally to be based upon a fear of the antitrust dangers supposedly stemming from conglomerate enterprises, especially large ones. Conglomerate financial holding companies conceivably may increase the likelihood that certain allegedly anticompetitive practices will occur. Of course, some of these practices will be just as likely, or more likely, to occur when the intermediary's affiliates are engaged in closely related activities. To make any sense of the activity restraints on affiliates, one must postulate a legislative intent to curtail the possible extent of such practices: financial conglomerates are basically to be outlawed, with exceptions for activities that may lead to vertical integration-type efficiencies. Nevertheless, well-founded skepticism about the frequency and seriousness of the alleged antitrust dangers, as well as the severity of existing antitrust doctrine, indicates that the risk of such practices as tying arrangements does not call for activity limits or for special antitrust regulation of conglomerate systems containing financial intermediaries. Nor does it appear that financial holding companies seriously increase concentration or adversely affect competition; there is not even evidence of realistic potential for a move toward a system of a very few, colossal, *zaibatsu*-like financial-industrial conglomerates. The case for going beyond, or for weakening, appropriate general antitrust policies and procedures has not been made.

On the other hand, holding company systems may threaten the soundness of their member banks, savings and loan associations, or insurance companies. These institutions may be adversely affected by a confusion in the public's mind of them and their affiliates, by fraudulent or unfair dealings with affiliates, and by a propensity for management to cause higher dividends to be paid by them or lower capital contributions to be made to them. The first danger calls for prohibitions against similar names. The second calls for a prohibition against dealings with affiliates (other than dividends and capital contributions). But exemptions could be granted by an administrative agency when the applicants clearly demonstrate that the proposed transaction will generate a significant "self-dealing surplus" — it will be better than a fair, or open-market, transaction — and that the intermediary will share significantly in it. Moreover, because the costs of the exemption procedure might deter some worthy requests for exemption, the rules governing financial intermediaries' own activities should be liberal enough to assure that closely related or ancillary activities which are most likely to generate self-dealing surplus can be internalized — a result that would substantially eliminate concern over unfair pricing or the provision of unnecessary or inappropriate services to the intermediary business. The preferred response to the third danger is to permit administrators of deposit insurance or insurance guaranty funds to charge premiums that vary with the indicated riskiness of the insured institutions. Net worth measures, regardless of whether they are affected mainly by dividends or by other factors, could be among the variables relevant to setting premiums.

In contrast to these recommended measures, limiting affiliates to lines of business that are closely related to the intermediary business fails to deal seriously with dangers to the intermediary's soundness. Indeed, in some respects this approach is perverse. By blithely permitting both externalization of ancillary activities and interaffiliate dealings, it needlessly subjects intermediaries to the possibility of harmful self-dealing. Such an expression of the separation theme, founded on vague fears of gigantic financial-industrial combines but oblivious to specific risks placed on intermediaries, defeats itself. The better legal policy is to reflect the true spirit of capitalism: stricter business ethics, but more business freedom.

The CHAIRMAN. Thank you very much. Mr. Ellis.

STATEMENT OF INMAN P. ELLIS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, OPPENHEIMER INTERCONTINENTIAL CORPORATION

Mr. ELLIS. Mr. Chairman, I apologize for not having a prepared speech. I received a call about 10 a.m. yesterday asking me to come up to Washington to appear before this committee. There was not enough time. Running a small business such as ours, there was not time for me to prepare a statement. I am presient and chief executive officer of Oppenheimer Intercontinental Corp. also known as Opico. We have been in business for 34 years exporting agricultural machinery and last year did business in excess of $13 million in over 80 countries around the world on all 6 continents. We have 14 men stationed overseas and 26 employees in Mobile. We represent approximately 40 U.S. manufacturers residing in 18 States around the country. I am a director of the National Association of Export Management Companies, a member of the region export council and we are recipients of the President's E Award.

Sitting and listening to the testimony of the previous people this morning, it makes me feel as a nonentity in this real world of Washington. My point being that there is already a well-established group trading internationally but we do not go under the name of the export trading companies. We are known as export management companies. Many firms of our association are quite large, much larger than ours.

I would like to submit a resolution (see exhibit A) of the NEXCO board of directors of the June 17 meeting. If I may I would like to read it.

[Exhibit A follows:]

EXHIBIT A

RESOLUTION OF NEXCO BOARD OF DIRECTORS—JUNE 17, 1980

The board of directors of NEXCO, The National Association of Export Companies, during their annual Board of Directors Meeting unanimously supported the following resolution on behalf of the 150 members of their organization, which includes Export Trading Companies and Export Management Companies throughout the United States:

"Be it resolved that NEXCO, through its Board of Directors, unanimously voted to oppose passage of the so-called Export Trading Company Act of 1980.

While the bill recognizes the importance of Export Trading Companies, the Export Trading Company Act of 1980 also provides for bank ownership of Export Trading companies. NEXCO feels that this would have adverse effect on the industry and on export in general and on the U.S. balance of trade. NEXCO feels that the encouragement of Export Trading Companies and of an export expansion does not require that banks be permitted to control Export Trading companies.

Instead, an Export Trading Company Act should have many other provisions for the encouragement and development of Export Trading Companies, which the present legislation lacks entirely.

Mr. ELLIS. The board of directors of NEXCO, the National Association of Exporting Management Companies during their annual board of directors' meeting unanimously supported the following resolution on behalf of the 150 members of their organization which includes export trading companies and export management companies throughout the United States:

Be it resolved that NEXCO through its board of directors unanimously voted to oppose passage of the so-called Export Trading Company Act of 1980. While the bill recognizes the importance of export trading companies, the Export Trading Company Act of 1980 also provides for bank ownership of export trading companies. NEXCO feels that this would have adverse effect on the industry and on export in general and on the U.S. balance of trade. NEXCO feels that the encouragement of export trading companies and of an export expansion does not require the banks be permitted to control export trading companies. Instead, an export trading company act should have many other provisions for the encouragement and development of the export trading companies which the present legislation lacks entirely.

CONVINCING THE AMERICAN MANUFACTURER

That is from the board of NEXCO. We are already working around the country with organizations that are well established. We have been successful. I can quote to you, for example, that the position that I face in our problem is it is not so difficult to sell the U.S. product overseas as it is to sell the U.S. manufacturer convicing him that he should export then we do in selling his products overseas, which is in our case the product that has made the American farmer the most efficient farmer in the world. Farm equipment dealers want the products that we sell but it is convincing the American manufacturer that we should have a fair share of their production output that is the real problem.

I cite as an example, the 1973–74 period when agricultural machinery was very much in demand. Some of our manufacturers did not even want our people to come to their sales meetings because they did not wish their domestic distributors to see they were exporting their products. This is the attitude of some of the U.S. manufacturers; that they do not realize the importance of exporting. My feeling is that we should have legislation that will help us export and whether it be EMC or ETC's or whatever it be, that we have something that will give us the help that is needed.

I would like to submit to the committee a letter that was written to a member of the export expansion committee of the Bankers Association for Foreign Trade at its annual meeting held in Hawaii in early May of this year (see exhibit B).

We favor anything that Congress can do to help us increase exports. I feel that not having a prepared statement, I would like to cut my remarks short at this time and be prepared to answer any questions.

The CHAIRMAN. Thank you. Let met start with Professor Clark——

Mr. ELLIS. Oh, I beg your pardon. I would like to ask if you would allow Mr. Joe Ducat, president of Brewster, Leeds & Co., to also make a statement. He accompanied me on this.

The CHAIRMAN. Very good. Do you have a short statement you would like to make?

STATEMENT OF J. B. DUCAT, PRESIDENT, BREWSTER, LEEDS & CO., INC.

Mr. DUCAT. Very short. I also apologize. I did not prepare myself for the trip. It is less than 24 hours that I learned I am supposed to come here. I would like to hand out to you a statement which I have made on May 22 before a House of Representatives committee. I am 35½ years with Brewster, Leeds. We are exporters of food products. We do business in 84 markets. We represent 72 American manufacturers. I am totally opposed that banks should participate in the export business to any degree and to any percentage. America has lots of talents to do export properly. We need help. We need help from the banks. We need help from Congress. We need help from anyone in this country who should understand how important export could be to this country. Banks particularly have been lame, have not helped us, have been slow in financial support. I just would like to give one example. That will be the end of my testimony.

BANKS SLOW IN FINANCIAL SUPPORT

If an American exporter gets a letter of credit, say, for $100,000 from a foreign buyer, and their firm, say, has only $5,000 capital, and the deal is absolutely clean and clear, and the exporter goes to the bank and submits this letter of credit to the bank and says please help me to pay the manufacturer because he does not give me any credit, the bank is going to ask him for a statement and is going to help him financially to the extent of his value, which is $5,000. Now convert this situation, let us say, to Holland. A Dutch exporter gets a $100,000 letter of credit. He has only $1,000 capital. He goes to the bank. The bank will give him at once at least the 90 percent it will cost, the $90,000. They may even given him some out of the $10,000 profit he makes. Banks in America do not help the exporter beyond his own financial value. It could change our situation drastically if banks would be helpful.

As I finish my statement on May 22, I would say let the banks for the next 5 to 10 years go and help the exporter and then let us review all the applications which they have made to become part of the exporter. Their performance has not justified that they should become partners in the American export field. Thank you.

[Exhibit B referred to earlier by Mr. Ellis follows:]

OPICO

"B"

POST OFFICE BOX 849 154 ST. LOUIS STREET MOBILE, ALABAMA 36601 USA
PHONE: (205) 438-9881 CABLE: OPICO MOBILE TELEX: 505462 REGISTRATION OFFICE: PANAMA

April 29, 1980

COPY

Mr. H.R. Vermilye, Vice President
Birmingham Trust National Bank
P.O. Box 2554
Birmingham, Alabama 35290

Dear Terry:

I was pleased to talk with you on the telephone today regarding the forthcoming meeting of the Export Expansion Committee of the Bankers Association for Foreign Trade and am pleased to furnish my thoughts on the proposed legislation currently before Congress having to do with the export trading companies.

Firstly, I favor anything that our Congress can do to help us increase exports.

An increase in exports for our country is of the upmost importance to its national economic well-being and if this legislation can accomplish that then it is very worthwhile. There certainly is a need for more companies specializing in exporting of American products. The figures as quoted by our Department of Commerce that only one in ten U.S. manufacturing firms are now exporting, is quite shocking.

The American product, whether it be agricultural machinery, agricultural products, industrial or consumer goods, is very much in demand overseas and generally far exceeds the quality available from other nations.

Most any discussion of the export trading companies brings forth a comparison with the successes that the Japanese have had with their very large trading companies. Certainly I would not be in favor of our federal government or any state agency, as such, attempting to copy the Japanese trading companies. The Yankee Trader first took U.S. goods to the world and we are capable without banks as competitors but as partners in their traditional banking role.

I have seen nothing in writing but I understand that Senator Adlai Stevenson in his bill S.2379 as introduced in Congress does specify that any benefits that would apply to "export trading companies" would also accrue to existing export management companies. This certainly is a must.

Although Secretary of Commerce Klutznick pointed out in recent Congressional testimony that there are some 700 to 800 export management companies throughout this country and that these firms are mostly small, typically lacking the resources to offer a full range of export services, I do not think that this description can be applied to every export management company.

"Exporters of Agricultural Equipment since 1946"

SALES OFFICES: AUSTRALIA COLOMBIA FRANCE COSTA RICA ENGLAND GERMANY MEXICO

PRESIDENT'S "E" AWARD FOR EXPORT SERVICE

OPICO

TO: Mr. H.R. Vermilye PAGE -2-

Certainly there are some fitting this category but at the same time there are a number of fairly substantial size EMC's measuring their sales in over $50,000,000 per annum.

The second bill that is before the Senate is S.864 (as introduced by Senator John Danforth of Missouri) applying itself more to the anti-trust laws for export activities. This is a must and again like the Stevenson bill, should also apply to export management companies.

Attached to this letter is a photocopy of the Business America, April 21st article on Expanding the Role of Export Trading Companies which I feel should be a part of this letter.

The export Trading Company Act mentions bank participation, Eximbank's role, DISC and Sub Chapter S tax provisions as well as anti-trust immunity. I would add to these a very strong plea for our Congress to reconsider the recent anti-boycott legislation that has severely hampered our nation's export of its products to the Middle East Countries.

I know of no U.S. firm regularly dealing in the Middle East which has not said at one time or another that if they did not have to wear the shackles of that legislative restriction, and often times harrassment, they could substantially increase their annual sales and therefore U.S. exports.

I do not feel that U.S. commercial banks should participate directly in export trading companies by making investments in these companies. Although this is done by some foreign countries it is my personal belief that the U.S. is better served to let the export management companies or export trading companies expand as separate entities with the help of the banks.

With very best regards,

Sincerely,

O P I C O

Inman P. Ellis
President
IPE/ksd

Article from Business America is printed at p. 361 of this volume.

The CHAIRMAN. Thank you very much.

I would like to ask Professor Clark about a statement you made. In your proposed testimony you said, and I quote:

> * * * two concerns about the bill appear to me to be misplaced. The first is the notion that bank ownership of noncontrolling stock interests in export trading companies may be tolerable, but controlling interests are beyond the pale. I am baffled by this distinction, for I do not see a clear connection between it and the likely degree of risk to bank soundness.

You were here when Governor Wallich testified. He was very explicit in saying why this was a problem. I will quote what he said and I would like your reaction to it.

He said:

> Where an ownership interest is 20 percent or more, the accepted standards of accounting normally call for a bank (or any company) to include on its balance sheet and income statement its proportional share of the net assets and earnings of a company. Experience in international banking has generally shown that where bank ownership in a foreign company permits the use of equity accounting, the bank frequently tends to become involved in management aspects of the business and to be identified with the company in the eyes of the financial community. Where such identification exists, a bank may find it necessary to stand behind all of the liabilities of a company in case of financial difficulties, in order to preserve the bank's standing in international financial markets. In the case of companies that are highly leveraged, a bank's potential loss could well be much larger than the original investment.

He indicated reference to REIT's and so forth and the sad experience we had with them. Why isn't that answer by Governor Wallich a good reason why ownership as compared to, say, a 20 percent limitation makes sense?

IGNORE LEGAL LIMITS

Mr. CLARK. I think it is defective for several reasons. First of all, it ignores the possibility of legal limits on the bank's involvement despite what they might dare to do in order to run the risk of preventing——

The CHAIRMAN. But the legal limits you refer to were the limits on the bank's own capital surplus. Under the bill, however, the bank would be unable to take an ownership interest which, as he points out, are more than 20 percent, which would require an entirely different accountability.

Mr. CLARK. The bank could never by any combination of extensions of credit, which in my opinion would include guarantees, plus equity investments, have more than an exposure of 10 percent of its consolidated capital and surplus.

The CHAIRMAN. Of its own capital and surplus.

Mr. CLARK. Yes, that is right. So you have an absolutely mechanical limit. You could also——

The CHAIRMAN. In the first place you leverage it. It might have, as he points out, you might have only a 5- or 10-percent interest as far as your own capital is concerned, but that involvement, because the company may be much larger than that and the implicit liability may be much greater, could be very much more serious for the bank.

Mr. CLARK. I do not see how that happens. Does the bank get sued if its stock goes down to zero value and it cannot collect under its loans?

The CHAIRMAN. He says where such identification exists, the bank may find it necessary to stand behind all the liabilities of the company.

Mr. CLARK. But not if legally prohibited from standing behind them.

The CHAIRMAN. We have case after case where it was so. They did that in the case of the REIT. That is why they got into trouble.

Mr. CLARK. And did not have controlling equity interest in them.

The CHAIRMAN. If they did they would have gotten in more trouble.

Mr. CLARK. I doubt it. I think the causes of the REIT collapse have little to do with bank involvement. I have a scholarly account of the REIT collapse here which I would give to anybody who wants to read it.

[The article referred to is reprinted at page 326 of this publication.]

The CHAIRMAN. I am told they did control the REIT's.

Mr. CLARK. They were not affiliated through stockholdings with them.

The CHAIRMAN. The advisers controlled the REIT's.

Mr. CLARK. That is true.

ANTICOMPETITIVENESS

The CHAIRMAN. Mr. Finley, you have indicated in your testimony that one of the reasons for the United States lack of market share is the anticompetitiveness of the market.

Mr. FINLEY. That is correct.

The CHAIRMAN. What type of positive action by Congress is necessary to facilitate bringing the goods of the agricultural sector and small- or medium-sized business into the export market? What do you think we can do positive to improve exports?

Mr. FINLEY. One of the things that would certainly help export would be to abolish Webb-Pomerene. We are talking about expanding it. We should talk about abolishing it.

The CHAIRMAN. How would that help increase our exports?

Mr. FINLEY. There are a number of Webb-Pomerene associations that restrict exports, claiming in their statements to FTC that they are to expand them. Actually, what they are doing is dominating domestic markets and export markets and depending on the price they can obtain in the foreign market——

The CHAIRMAN. In your experience, they fix prices so competitors would come into this at a lower price and could win export contracts aren't able to do so.

Mr. FINLEY. That is correct. This state of affairs brought in competition, for example, in sulfur in Mexico. Years ago, we had Sulphur Export Corp., a Webb-Pomerene association, which at that time dominated the market. But because it provided an umbrella-like protection for the world market, Mexico was able to enter and now Mexico and others are formidable competitors.

We have the same situation in phosphates. There is a long history of phosphatic exports wherein they were dominated by Webb-Pomerene associations and these provide an umbrella for foreign competition to enter world markets.

They were not competing against cartels. They were actually protecting the market so other cartels could function with them, but they would not let us—U.S.—exporters compete against them.

The CHAIRMAN. How do you meet the argument that the countries that have done very well in the export area have a higher concentration and a more aggressive kind of direction, control, and discipline than we have and they would go along the same lines this bill would go?

Mr. FINLEY. Mr. Chairman, if you are referring to Japan, for example——

The CHAIRMAN. That is the prime example. Other countries too.

Mr. FINLEY. I will use that. Japan had the government, industry, and labor combined into one and controlled centrally.

If our country is prepared to control centrally labor, capital, and control it to the extent that Japan had been controlling it from, say, 1948 through today, then we are talking about something else other than free enterprise.

Conversely, I would like to point out that today Japan is having second thoughts on the subject of their machine and there is a lot of talk about breaking up some of the combines in Japan. So perhaps when we say today that we should imitate Japan, we are running perhaps 30 years behind because they are thinking of dismantling this machine.

The CHAIRMAN. Do you know in Japan whether or not the banks actually do control the trading companies?

Mr. FINLEY. To a large extent they do.

The CHAIRMAN. Are you sure of that? We had information that they do not.

Mr. FINLEY. I say to some extent. I would like to explain that: Trading companies in Japan represent a totally different picture to the trading companies that are proposed here and to the trading companies that are generally represented as being an export organization here in the States. The Japanese trading company is involved in all phases of economic activity. It starts out from production and goes through distribution, financing, et cetera. So if the bank has a hold on a trading company, it probably has a hold on the financing aspect of these various activities. But it does not have a direct control over the activities of any trading company there.

To the extent that they lend the money for each and every activity, to that extent they do exercise a certain amount of control and it could be quite substantial.

The CHAIRMAN. Let me ask Mr. Ellis, it has been contended it is necessary for banks to be involved in the export trading companies as investors for the concept to fully succeed.

As an experienced exporter, and you certainly are, what is your view of the necessary role for banks? Both you and Mr. Ducat indicated the banks could play an important, constructive role. I am not completely clear in my mind as to precisely what you think they should do. Could you tell us?

RESTRICTIVE LAWS HAMPER EXPORT EFFORTS

Mr. ELLIS. Perhaps I should answer this very carefully since I have two bankers on my board. We work very closely with the banks, both in New York and our local banks in Mobile. Banks can play a far more important role and a more meaningful role if they did not have the restrictive laws that are hampering our export efforts and if they had the support of—for example, the FCIA, Exim and more funds made available to back up our sales.

Banks can provide services but I do not know where the banks could get the expertise that we EMC's, for example, have today. It would just take years to formulate these new trading companies and get the people trained to be effective. Trained people we already have we are hampered by ineffective export policies of our Government and a lack of desire to export by American manufacturers.

The CHAIRMAN. Mr. Ducat gave us a fine example with the letter of credit instance of how the banks could be more reasonable. Would not the banks be more likely to be involved that way if they had ownership, if they had that kind of equity and protection that equity might give them?

Mr. DUCAT. It is my experience that New York banks have hardly any knowledge at all of what goes on in the export business.

In my last statement on May 22, I said when I listened to this 3½-hour meeting, I wondered whether all the gentlemen, particularly those representing banks, but also the panel, House of Representatives, if they ever looked up in an American Anglo dictionary and saw the name export there, we are talking constantly about export trading companies as if we were inventing something new.

America has not known anything else, but we just speak about manufacturers and banks. Now we are creating export trading companies. We have thousands of skilled exporters here in America—exporting management companies. If you speak to most of them, and I would say for myself I have no complaint about my bank. They have been great to me for 35 years. But if you speak to most of the bankers—I am sorry, most of the exporters—you will find that their support from their banks financially or technically is unsavory.

The CHAIRMAN. My time is up. If you would permit Mr. Ellis to respond? Go ahead.

Mr. ELLIS. I can cite a recent example where we were trying to secure a letter of credit as a performance guarantee for a Middle East bid. The banks' inability and refusal to provide this letter of credit against our existing line of credit prevented us from bidding—as in the case of one bank coming to us and saying: "We will not give you money or letters of credit for guarantees except against your certificates-of-deposit that are held by the bank." I think this sort of thing is where the banks fall short and could be of a great deal more service than they are.

The CHAIRMAN. Thank you. Senator Stevenson.

Senator STEVENSON. One of the objectives of the legislation is to get the bank to be more actively involved.

Professor Clark, do you have any response to the arguments that the bill is anticompetitive?

Mr. CLARK. Do you mean do I have any comments about the proposed changes in the Webb-Pomerene Act? No; I don't feel competent to judge on that.

Senator STEVENSON. Well, Mr. Chairman, I don't want to prolong this. We have a lengthy record on the Webb-Pomerene as well as the banking and other issues here. I would thank our witnesses for their assistance. I would just point out in conclusion that the opposition of which I am aware comes from organizations which might experience more competition as a result of this legislation. Thank you.

The CHAIRMAN. That is not true with the FDIC and Federal Reserve. [Laughter.]

LAW WILL BENEFIT ETC AND EMC

Mr. ELLIS. I wanted to ask a question. Will the benefits of this new act, should it be made into law, accrue to the existing export management companies? This is something that has bothered the export management companies a great deal in this legislation. Everywhere we see the ETC and all its benefits contained therein going to them, but no mention of export management companies.

The CHAIRMAN. This is a question for Senator Stevenson. He authored the bill. I am sure the purpose of this is to stimulate our exports and the great need we have in our country for additional activity, additional jobs, additional economic opportunity for strengthening our foreign trade position.

We are all very anxious to do that anyway we can. Certainly if this has benefit for the banks or export companies or the manufacturers, that is fine. But our fundamental concern is the overall national—I will let Senator Stevenson answer that.

Mr. ELLIS. I would appreciate it if he would.

Senator STEVENSON. The purpose—yes; you have to be principally organized, but I would think most export managing companies would be principally organized for export trading purposes.

Many of them do support this bill because they see some real benefits in it for them. Some of those benefits are very much in line with your complaints, Mr. Ducat. They include EDA, SBA, Exim, financing of accounts receivable and inventory held for trade. One of the purposes of the financing is not just to make it available through the government institutions, but to use them as a way of getting the banks cooperatively involved to a larger extent in financing trade. They work in part in cooperation with the Eximbank, of course, now.

With this new authority, there will be new cooperative opportunities for the banks to provide inventory, foreign accounts receivable financing, et cetera. I offhand see no reason on earth why typical export management companies would be prevented, and we certainly can give them the benefits of this legislation.

If there is anything more we can do to make it clear, to make sure it materializes in a way that benefits the kind of companies you are involved in and represent, I would welcome the suggestions.

Mr. FINLEY. The question was not addressed to me, but I can not understand why—my instinct tells me that if this bill is passed, small and medium management—export management companies, small- and medium-sized exporters and even some of the big ones will be wiped clean just like the corner grocery.

Semator STEVENSON. By competition?

Mr. FINLEY. No; there is no competition. Not enough competition. I am sorry that you feel that way. I am engaged in exports every day. What Mr. Ellis said is absolutely true. Our manufacturers do not want to compete. This is why many of the manufacturers want to band together with the banks so they could compete less. It is the exporters that want to compete. I think that we should make the distinction very clear. The manufacturers of America, by and large, not every one, do not wish to compete. We have some very fine companies such as Caterpillar which was mentioned here and many others, but there are many others that do not wish to compete. They want to think in terms of higher prices first and foremost.

Senator STEVENSON. I agree with the gentleman's observation about American business. But not your conclusion.

The CHAIRMAN. Gentlemen, I want to say your testimony was very good. All morning we had good and helpful testimony. If we had this a little earlier before the committee acted on the bill, we might have had a better bill.

The committee will stand adjourned.

[Whereupon at 1 p.m. the hearing was adjourned.]

[Additional statements and data supplied for the record follows:]

NEWS RELEASE

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

For RELEASE

Date July 25, 1980

(202) 447-1800

STATEMENT OF
JOHN G. HEIMANN
COMPTROLLER OF THE CURRENCY
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND
URBAN AFFAIRS
U.S. SENATE
JULY 25, 1980

This is in response to the Committee's request for the views of the Office of the Comptroller of the Currency on the "Export Trading Company Act of 1980" (S. 2718). We welcome the opportunity to comment on this legislative proposal. Our comments are limited to those provisions which permit bank participation in new export trading ventures.

S. 2718 is designed to promote the expansion of U.S. exports through the formation and operation of export trading companies ("ETCs") to facilitate the export of goods and services on behalf of small- and medium-sized firms. The bill provides for a significant role for U.S. banking organizations as an important component of the promotion of exports by permitting their investment in and ownership of ETCs.

This Office supports the concept of export trading companies and urges the enactment of this legislation. Our national interests require the strengthening of U.S. competitiveness in world markets. The proposed ETCs appear to be a viable means to further that national objective. Various testimony on S. 2718 and similar bills has strongly advocated bank participation as an essential element to successful trading company operations. ETCs require the capital, financing, financially-related services, and marketing capacities which U.S. banking organizations can provide through their national and international networks to small- and medium-sized firms across the U.S. We believe that it is necessary for a significant role to be taken by banks to assure the success of ETC operations.

While the degree of future bank participation in ETCs, and the forms that such participation may take, remain unclear at this early conceptual stage of developing a U.S. model for trading companies, we do anticipate a wide range of bank lending to and investment in ETCs. This would reflect the diversity of probable bank participants as well as the diversity of the local and regional businesses which ETCs would serve. Permitting banks to have equity interests in ETCs would be a long-term incentive for them to establish the additional organizational framework necessary for them to provide a complete range of services to effectively promote exports of goods and services. A bank prudentially may require a controlling interest in an ETC in which it becomes an active participant. For these reasons we do not want to foreclose a bank's ability to acquire such an interest. Accordingly, we support ownership of ETCs by banking organizations if the reasonable supervisory safeguards in S. 2718 are enacted.

Equity participation by banks in ETCs would to a limited extent breach the traditional policy of separating banking and commerce. However, we believe that S. 2718 addresses the national interest of export promotion in a way which preserves the safety and soundness of the banking system. The Congress has previously permitted limited bank participation in commercial activities over the past 60 years to accommodate particular national needs--our current trade imbalances require similar legislative action.

A healthy and expanding export sector has become increasingly essential to a strong U.S. economy, the stability of our external accounts, and our critical fight against inflation. Exports contribute significantly to U.S. employment, production and growth; enable economies of scale which contribute to the efficient use of resources and reduced prices; and provide a constructive method for the payment for U.S. imports of essential and desired commodities. U.S. industries must be able to compete abroad if they are to maintain their ability to compete at home.

The Commerce Department reports that only 10% of the 250,000 U.S. manufacturing firms export their products and that total U.S. exports account for the lowest percentage of gross national product of any industrialized nation. Also, 95% of U.S. manufacturing firms are small- or medium-sized companies which employ less than a thousand persons. These companies represent a small share of exports, about 10-15% of total U.S. exports. Conversely, most U.S. exports are the sales of a small number of U.S. firms. Approximately 100 U.S. firms account for 50% of the total exports of U.S. manufacturers. The purpose of this bill is to strengthen the international competitiveness of the U.S. by providing small- and medium-sized U.S. firms increased opportunities to export. At present, these firms face a number of structural obstacles and disincentives to exporting which are difficult for the independent firm to overcome.

Flexible ETC Services

At the present time, small- and medium-sized U.S. firms have four primary methods available by which they may export goods and services. They may: sell directly to foreign end-users; sell through foreign agents or brokers; sell through U.S. export management companies; or, find a large U.S. multinational firm that needs certain products for specific overseas activities. These methods apparently have not provided U.S. firms with adequate opportunities to export their goods and services. These methods entail problems for small- or medium-sized firms which act as disincentives to exporting. Such practical barriers include:

- Selling directly overseas ties up the current cash flow of U.S. firms because of slower payment time than in the domestic market.

- Foreign export agents or brokers often demand total product control and extremely flexible pricing.

- The majority of export management companies lack the expertise to handle more than one or two specialized product lines. Most of these companies lack the management and capital necessary to expand geographically and to establish overseas sales offices.

- Generally, large U.S. multinational firms do not directly involve smaller firms in foreign trade.

Besides these difficulties, small- and medium-sized U.S firms lack other necessary capabilities and expertise such as specialized knowledge of markets to match specific product demands, funds for the development of a foreign market for their particular products, adequate working capital, and adequate financing for foreign purchasers of goods or services. These problems have substantially contributed to the lack of participation of many small- and medium-sized U.S. firms in export trade.

The export trading companies would be an alternative to the existing cumbersome export mechanisms and would encourage the involvement of small- and medium-sized U.S. firms in export trade. As demonstrated by the successful operation of export trading companies in other countries, an export trading company can develop and provide an integrated package of managerial and financial services to facilitate exports. Export trading companies, through volume transactions, also permit economies of scale to reduce the costs of exporting goods or services by U.S. firms.

Export trading companies abroad have proved to be effective. They act as more than intermediaries handling a broad spectrum of products. Export trading companies not only function as a bridge between suppliers and users of products but also provide many other services essential to successful exporting. For example, an export trading company may offer expertise in financing, credit services, market analysis, distribution channels, documentation, leasing, communications, accounting, foreign exchange and advertising. Essentially, an export trading company reduces the requirements for special expertise and capital investment of firms interested in exporting. U.S. businesses should not be deprived of the same advantages as those enjoyed by foreign competitors through their access to such foreign ETC exporting assistance.

The Role For Banks

U.S. banking organizations should play a significant role in the development of export trading companies. They can contribute significantly to U.S. export capabilities in several ways. First, banks have extensive national and international networks comprised of branches, subsidiaries, affiliates, representative offices and correspondent relationships. These networks not only can provide essential marketing and other services abroad but, more importantly, these networks extend throughout the U.S. touching virtually all small- and medium-sized firms. Second, U.S. banks can provide through that network a wide range of export-related financing as well as ancillary services, such as assistance and guidance in the identification of foreign markets, foreign exchange, trade documentation, transportation and warehousing. Third, banks can provide export trading companies and exporters the financing necessary for export transactions.

Major foreign banks which are involved in export trading companies provide a convenient single-source service for exporters abroad. U.S. banks, however, are not authorized under existing laws to offer the complete range of services essential to attracting small- and medium-sized U.S. firms into exporting their goods and services. Traditionally, the export promotion efforts of U.S. banking organizations have been adjunct to overall commercial lending because their operations have been legally confined to those activities which are considered to be closely related to the business of banking. U.S. banking organizations have the systems, skills, and experience necessary to provide one-stop export services to U.S. firms but need broader authority to do so. S. 2718 would provide that authority by permitting participation in ETCs by banking organizations.

U.S. bank investment in ETCs would facililitate achievement of the underlying purposes of the proposed legislation. With equity participations in ETCs, banks could readily package essential one-stop exporting services which would greatly reduce the expertise and overhead expenses required of individual firms seeking to sell abroad.

There are other reasons why S. 2718 properly permits U.S. banks to invest in ETCs. First, the investment authorities contained in S. 2718 would increase the number of possible investors and available capital to form ETCs. Second, banks with their international offices, experience in trade financing, and familiarity with domestic U.S. producers, are likely sources of leadership in forming ETCs. They possess many of the skills important to ETC organization and management. Third, their investment in ETCs would provide banking organizations with an incentive to create the long-term organizational framework necessary to accommodate export promotion as a mainstream function. Finally, by permitting U.S. banking organizations to hold equity investments in ETCs, S. 2718 would rationalize the present system of authorities. U.S. banks are presently permitted to be involved in foreign ETCs which can buy and sell goods and services abroad. Foreign banks operating in the United States may also own a foreign ETC which can export goods to the United States.

We do not know, however, the degree and forms of participation that U.S. banks may develop with ETCs. We also cannot forecast whether banks would immediately begin to organize ETCs should this bill be enacted. We are only working with a conceptual model for ETCs at this time. However, we anticipate that, should the legislation be passed, U.S. banks over time would develop ETC relationships suited to the wide range of commercial transactions generated by their own local and regional economies. We are confident that U.S. multinational banks would seize any new opportunities in this area. Moreover, multinational and regional banks would also offer ETC facilities and participations to local banks and firms through joint ventures.

We support the provisions of S. 2718 which provide for U.S. banking organizations to own a controlling interest in ETCs. This Office generally prefers banks to have equity and management control over their affiliate relationships rather than have that capital exposed to decisions by majority non-bank partners. It also is reasonable to expect banks to be more inclined to form ETCs if the banks can control their investment and the ETC's activities. The unfavorable bank experiences during the early 1970's with less than controlling participations in REITs, foreign banks and finance companies have led U.S. banks to adopt investment strategies which generally avoid non-controlling positions in affiliates.

We recognize that equity participation by U.S. banking organizations in ETCs would represent an exception to traditional policy which separates banking and commerce. However, we believe that the proposed legislation is consistent with previous exceptions Congress has made in order to further necessary national policies. Congress has permitted banks to own equity participations in Edge Act Corporations, international financial or holding companies, commercial corporations oriented towards national or community purposes, and bank service and other banking related entities. Similarly, we believe this bill addresses the national interest (of export promotion) in a way which preserves the safety and soundness of U.S. banking system.

Supervisory Safeguards

The proposed legislation contains several necessary supervisory safeguards regarding U.S. bank involvement in ETCs. First,

S. 2718 addresses entry and aggregate investment limitations: U.S. banks could not invest more than $10 million or acquire a controlling interest in an ETC without prior agency approval; a U.S. bank would not be permitted to invest more than 5% of its capital and surplus in the stock of one or more ETCs; the aggregate amount of loans and investments a U.S. bank could make in an ETC would be limited to 10% of the bank's capital funds; and, no group of banks could acquire more than 50% of an ETC without prior agency approval, even if no one bank were to acquire a controlling interest, and no bank were to invest $10 million or more.

Second, the legislation would also establish several other restrictions on banking organization investors and ETCs. For example, the name of an ETC could not be similar in any respect to that of an banking organization investor. If an ETC takes speculative positions in commodities, all banking organization investors would be required to terminate their ownership interests. A banking organization would be prohibited from making preferential loans to any ETC in which it has any interest, or to any customers of such an ETC. These limitations and restrictions have been structured to provide minimal financial exposure by banking organizations in ETCs and to prevent conflicts of interest.

Most importantly, S. 2718 provides substantial regulatory flexibility to the federal financial supervisory agencies to control investments by banking organizations in ETCs. If an agency determines that the anticipated export benefits of an investment are outweighed by adverse banking factors, the agency may disapprove an investment application submitted by a particular bank. Controlling investments in ETCs by banking organizations can otherwise be limited by (1) conditions imposed by the agencies to limit a banking organization's financial exposure or to prevent possible conflicts of interest or unsound banking practices; and (2) standards set by the agencies regarding the taking of title to goods and inventory by the ETC subsidiary, to ensure against unsafe or unsound practices that could adversely affect a controlling banking organization. The agencies may examine bank-controlled ETCs and may use their cease-and-desist authority to enforce any and all requirements of the law. The agencies may also require divestiture of any ETC investment that would constitute a serious risk to a banking organization investor.

These provisions adequately mitigate the supervisory concerns which we expressed regarding earlier proposals as to the safety and soundness of participating national banks. We do not feel, therefore, that additional statutory restrictions--such as a specific limit on the maximum interest a banking organization may have in an ETC, or a minimum capital ratio for bank-owned ETCs--

need be enacted. As you know, Edge Act Corporations (EACs) must now operate within a leveraging regulation which requires paid-in capital and surplus to equal at least seven percent of an EAC's consolidated risk assets. The administrative authority granted to the federal agencies by S. 2718, in our opinion, will allow similar requirements to be imposed upon bank-owned ETCs through implementing regulations, with appropriate variations to take account of different types of permissible ETC activities. We believe that such regulatory authority to fashion particular limitations is preferable to a specific statutory provision.

While we support this legislation, we recommend that certain amendments be adopted. First, the definition of "export trading company" should be clarified to limit non-exporting activities by ETCs to conduct which facilitates U.S. exports, such as activities necessarily involved in international barter arrangements. The bill, as presently drafted, defines an ETC as a company organized and operated "principally" to export U.S. goods and services, among other activities. This definition should be supplemented by a requirement that all activities of an ETC be "related to" international trade.

Second, the specific time limits for agency disposition of investment applications should be extended. S. 2718 requires agency action within 60 days of written notice from a banking organization of its intention to make additional investments or to

66-942 0 - 80 - 19

have an ETC undertake certain activities. S. 2718 would require agency action within 90 days of notice from a banking organization of its intention to make an investment of $10 million or more or to acquire a controlling investment in an ETC. We suggest that these time limits be extended to 90 days in the former case, 120 days in the latter. In either case, an agency's failure to disapprove or impose conditions on a proposed investment within the appropriate time limit would result in the investment being deemed approved. We believe that the additional 30 days will allow the appropriate agencies to give more extensive considerations to new investment or activity proposals. At a minimum, specific statutory authority should be provided for the agencies to extend the time period in appropriate cases.

We fully support the objectives of S. 2718--encouraging the efficient provision of export trade services to U.S. producers and suppliers. The restrictions on bank involvement should adequately protect depositors of banking organizations which choose to participate in the management of ETCs. The limited opening of this area of activity to banks will create a unique U.S. export trading company system to allow more U.S. producers to benefit from existing international marketing networks and trade financing expertise.

CSBS CONFERENCE OF STATE BANK SUPERVISORS

REC'D JUL 24 AM 12:17

OFFICE OF THE EXECUTIVE VICE PRESIDENT-ECONOMIST

July 24, 1980

Senator William Proxmire, Chairman
Senate Committee on Banking, Housing
and Urban Affairs
5241 Dirksen Senate Office Building
Washingotn, D.C. 20515

Dear Senator Proxmire:

Re: S. 2718 - The Export Trading Company Act of 1980

In accordance with your request for comments by the Conference of State Bank Supervisors regarding the above bill, this is to advise that the Conference shares your concerns that this bill would violate the principle of the separation of banking and commerce, which concept has done much to prevent an unhealthy concentration of economic power in this country. Bank equity in nonbanking enterprises, like government equity is the worst type of contrived credit allocation.

While we are supportive of the stated objective to increase U.S. exports, we believe that to permit banks to hold a controlling equity interest in export trading companies would raise serious regulatory problems of the type which the Federal Reserve Board and the FDIC have spelled out in communications on this bill.

The worthy goal of increased exports can be achieved more effectively by reducing government-related burdens on producers of goods and services which might be sold abroad. High taxes, government-fed inflation, consequent high interest rates, government-sponsored labor monopoly, related high labor costs and direct control adversary-type government regulations, all merit attention ahead of another government program--particularly one which has all the ingredients of more, not less, regulatory burdens. The Export Trading Company Act of 1980 inevitably would take on more of the characteristics of high government costs and a bureaucratic power structure than of export expansion.

1015 EIGHTEENTH STREET, N.W. • WASHINGTON, D.C. 20036 • (202) 296-2840

Finally, representing the primary chartering and regulatory source for state-chartered commercial banks, the Conference must express its strong objection to those provisions in S. 2718 which would permit state-chartered commercial banks to take equity positions in business enterprises in violation of state banking codes banning such action. This proposed action would constitute a serious preemption of state authority to determine the operating powers of banks which they charter and supervise. Certainly in the absence of some overriding national policy considerations, which we do not perceive here, CSBS must object to those statutory provisions in S. 2718 which would enlarge state-chartered banks' powers beyond those which a state authorizes for its institutions.

Sincerely,

Lawrence E. Kreider
Executive Vice President-
Economist

/lsg

Calendar No. 785

96TH CONGRESS 2d Session	SENATE	REPORT No. 96-735

EXPORT TRADING COMPANIES, TRADE ASSOCIATIONS, AND TRADE SERVICES

MAY 15 (legislative day, JANUARY 3, 1980).—Ordered to be printed

Mr. STEVENSON (for himself and Messrs. HEINZ, BENTSEN, ROTH, GLENN, SCHMITT, MELCHER, TSONGAS, LUGAR, STEWART, and JAVITS), from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[To accompany S. 2718]

The Committee on Banking, Housing, and Urban Affairs, to which was referred the bill (S. 2718) to encourage exports by facilitating the formation and operation of export trading companies, export trade associations, and the expansion of export trade services generally, having considered the same, reports favorably thereon and recommends that the bill do pass.

HISTORY OF THE LEGISLATION

The concept of legislation to encourage the formation of U.S. trading companies was discussed at hearings on U.S. export policy held in early 1978 by the Subcommittee on International Finance (see, in particular, parts 3, 6, 7, and 8 of those hearings). The Subcommittee's report on the need for a U.S. export policy, issued in March 1979, included a recommendation that U.S. export trading companies be established to expand exports of the products of smaller U.S. producers and that the Webb-Pomerene Act be revised to clarify antitrust treatment of export activity.

S. 1663, the Export Trading Company Act of 1979, was introduced by Senator Stevenson on August 2, 1979, and referred jointly to the Committees on Banking, Housing, and Urban Affairs and Finance. Hearings were held on the bill before the Subcommittee on International Finance on September 17 and 18, 1979. Also considered during the hearings were three bills to amend the Webb-Pomerene Export Trade Act of 1918 concerning export trade associations: S. 864, the

Export Trade Association Act of 1979, introduced by Senators Danforth, Bentsen, Chafee, Javits and Mathias on April 4, 1979; S. 1499, the Export Trade Activities Act, introduced by Senator Roth on July 12, 1979; and S. 1744, introduced on September 13, 1979, by Senator Stevenson for Senator Inouye.

The Subcommittee received testimony from Luther H. Hodges, Jr., Under Secretary of Commerce; C. Fred Bergsten, Assistant Secretary of the Treasury for International Affairs; Ky P. Ewing, Deputy Assistant Attorney General in the Antitrust Division of the Justice Department; Daniel Schwartz, Deputy Director of the Bureau of Competition of the Federal Trade Commission; Senators Danforth, Bentsen, Chafee, Mathias and Javits; and a number of other witnesses. The testimony ranged across all the issues raised in the bills: antitrust treatment of trade associations and trading companies, tax treatment of export trading companies, Federal assistance for start-up costs and financial leverage of export trading companies, and bank ownership of export trading companies.

A new bill, S. 2379, the Export Trading Company Act of 1980, was introduced on March 4, 1980, by Senators Stevenson, Heinz, Javits, Bentsen and Glenn. The bill contained revised versions of each of the basic provisions of S. 1663. On February 26, 1980, Senators Danforth, Bentsen, Chafee, Mathias and Javits introduced a revised version of their legislation to reform the Webb-Pomerene Act: Amendment 1674 to S. 864.

Hearings were held on the revised legislative proposals on March 17 and 18, and April 3, 1980. Testimony was received from Secretary of Commerce Philip Klutznick, speaking on behalf of the Administration and accompanied by Assistant Secretary of the Treasury C. Fred Bergsten, Deputy U.S. Trade Representative Robert Hormats, and Assistant Secretary of State for Economic Affairs Deane Hinton; Deputy Assistant Secretary of State Erland Heginbotham (who appeared in his individual capacity as an expert on Asian trade); Governor Henry Wallich of the Board of Governors of the Federal Reserve System, (who was unable to appear in person due to foreign travel commitments): W. Paul Cooper, President of Acme-Cleveland Corporation and representing the National Machine Tool Builders Association; J. D. Minutilli, President of Commercial Credit Company; Ted D. Taubeneck, President of Rockwell International Trading Company and representing the Chamber of Commerce of the United States; E. Anthony Newton, Senior Vice President of Philadelphia National Bank; James B. Sommers, President, the Bankers Association for Foreign Trade and Executive Vice President of North Carolina National Bank; Lawrence A. Fox, Vice President of the National Association of Manufacturers; Jerry L. Hester, President of International Trade Operations, Inc.; Robert L. McNeill, Executive Vice Chairman of the Emergency Committee for American Trade; John R. Liebman, General Counsel of the Export Managers Association of California, Inc.; Ruth Schueler, President of Schueler and Company, Inc., representing the Subcommittee on Export Promotion of the President's Export Council; and Thomas M. Rees, representing the Task Force on International Trade of the White House Conference on Small Business.

The full Committee marked up a Committee print on May 12, 1980, which contained revised versions of S. 2379 and Amendment 1674 to S. 864, and agreed to report favorably an original Committee bill.

Purpose of the Legislation

The purpose of the legislation is to improve U.S. export performance by facilitating the creation of U.S. export trading companies which could perform export services for tens of thousands of small and medium-sized American producers. Despite the success of trading companies as "export middlemen" for European, Japanese, and Korean producers, such companies have been slow to develop in the U.S. due to deterrents presented by banking regulations, antitrust uncertainties, and the traditional insularity of the U.S. market. This legislation modifies provisions of existing law which have acted to discourage the establishment or expansion of export trading companies, and offers modest incentives to the development of such companies.

The bill would provide for certification of antitrust exemption for specified export trade activities of such companies and of export trade associations; afford tax and financing incentives to encourage formation and growth of export trading companies, including existing export management companies; direct the Export-Import Bank to develop an improved guarantee program to support commercial loans to U.S. exporters; require the Secretary of Commerce to provide information to U.S. producers regarding export trading companies and other firms offering export trade services; and permit banks and banking institutions to make limited investments in export trading companies. The legislation is intended to lay the basis for a significant expansion of export services and, thereby, U.S. exports.

Need for the Legislation

This legislation is necessary to encourage the formation of export trading companies and export trade associations designed to link potential U.S. exporters with overseas markets. The Department of Commerce and others have estimated up to 20,000 U.S. manufacturers and agricultural producers offer goods and services which could be highly competitive abroad. Yet the small size and inexperience of these firms leave them ill-equipped to absorb the front-end costs and risks involved in developing overseas markets.

Greater efforts to encourage and assist U.S. producers to export directly are desirable, but for most producers the marginal costs of developing fully their export opportunities abroad will prove prohibitive. Export expansion on the scale required to offset U.S. trade deficits will depend on the development of intermediaries, including export trading companies, which, by diversifying trade risk and developing economies of scale in marketing, financing, and other export trade services, can do the exporting for large numbers of U.S. producers.

Although a variety of existing enterprises do provide export services to U.S. producers—freight forwarders, brokers, shippers, insurance companies, comercial banks, export management companies, advertising firms, trade lawyers, foreign purchasing agents, and others—most fulfill only one or a few of the many functions required to engage in export trade. In constrast, most European countries, as well as Japan and Korea, possess sophisticated, large-scale general purpose trading companies which perform the full range of requisite functions for potential exporters; the success of such companies has contributed significantly to the export earnings of all of our major trade competitors.

4

Despite the similar success of foreign-owned export trading companies operating in the U.S. over the past few years, the growth of U.S.-owned export trading companies has been slow, except in a few sectors such as grain and raw materials trade.

If U.S. export trading companies are a sound business proposition, why have not the working of the marketplace and American enterpreneurship produced such companies already? First, the U.S. domestic market has been much larger and more prosperous than foreign markets—until recently. Belatedly U.S. companies are beginning to see the greater growth possibilities in foreign markets, but foreign producers are already well organized for exporting and can offer quality products at competitive prices. Second, many foreign markets have been largely closed to U.S. exporters. China is an extreme example, but Japan and other countries have maintained high tariff walls and nontrariff barriers to imports almost as effective as the isolation of China. Due to the recently concluded Multilateral Trade Agreements in GATT and persistent U.S. bilateral efforts, trade barriers are being reduced. Foreign competitors, however, with a longer history of aggressive exporting, are better poised to seize these new market opportunities; U.S. negotiating successes may only be opening markets for our competitors. Finally, U.S. laws and regulations, as well as traditional business and banking practices, have discouraged cooperative export trading companies, export trade associations, or bank participation in export trade activity.

Legislation is needed to remove these deterrents and to encourage the formation and growth of general purpose export trading companies by means of tax and financing incentives. Rapid formation of export trading companies on a scale sufficient to affect overall U.S. export levels will require the involvement of banks and major corporations, whose financial resources, international marketing networks and trade financing experience position them well to play a major role in the establishment of export trading companies. This legislation is needed to enable banks and banking institutions to make limited investments in export trading companies, subject to prior approval and conditions imposed by Federal bank regulatory agencies for all controlling investments.

The bill also provides for revision of the Webb-Pomerene Act of 1918 to clarify the antitrust provisions applicable to export trade associations and to provide a certification procedure enabling export trading companies and other such associations to receive antitrust clearance for specified export trade activities. The lack of clear cut antitrust immunity provided exporters by the 1918 legislation and the exclusion of services from its coverage has severely limited the statute's effect on exports. Under the review procedures established by the present legislation any U.S. company may determine in advance exactly which export trade activities would be immune from antitrust suit and organize its operations accordingly.

In order to encourage the direct involvement of smaller exporters in the formation of export trading companies, the legislation urges the Economic Development Administration and the Small Business Administration to give special attention to the financng needs of small and medium-sized concerns interested in exploring export opportunities in this manner. It authorizes an additional $20 million per year in fiscal years 1981 through 1985 to EDA and SBA to support loans or guarantees for these purposes.

This legislation would also improve the financial leverage of export trading companies. It directs the EXIM Bank to establish an expanded guarantee program for commercial credits secured by export accounts receivable or inventory held for exportation, if the Board of Directors of the Bank determines the private credit market is inadequate and EXIM guarantees would facilitate exports which would not otherwise occur.

The bill would direct the Secretary of Commerce to promote actively the formation of export trading companies and the dissemination of information about related export opportunities.

Finally, the legislation would extend the tax deferral available under the DISC (Domestic International Sales Corporation) provisions of the tax code to all export trading company income, derived from exports handled or the provision of trade services. The use of subpart S of the tax code, permitting certain passthroughs to shareholders of closely held corporations, would be allowed for some export trading companies. The Department of Commerce, with the assistance of the International Revenue Service, is directed to prepare a guide to help export trading companies form DISCs or elect subpart S tax treatment.

These provisions would remove the most serious deterrents to the emergence of significant U.S. export trading companies. The legislation would foster competition by decreasing government regulation, and would offer the potential for greatly increased U.S. export competitiveness with minimal direct Federal government participation.

EXPLANATION OF THE BILL

TITLE I—EXPORT TRADING COMPANIES

1. Definitions

The bill defines an export trading company as a U.S. company "organized and operated principally for the purposes of: (A) exporting goods or services produced in the United States; and (B) facilitating the exportation of goods and services produced in the United States by unaffiliated persons by providing one or more export trade services." The definition is intended to encompass most existing firms which offer export trade services to U.S. producers to whom they are not affiliated, while doing some exporting at their own risk. Many of these American firms, called export management companies or trading companies, are very small and have difficulty obtaining adequate financing to expand their operations. Encouragement and assistance to such firms are major objectives of the legislation.

The definition of an export trading company is meant to exclude firms by any name which export solely the goods or services of the company itself, its parent company or its subsidiaries, or other members of the corporate family. Many major American corporations have subsidiaries which may be called trading companies, but which in fact export only the products of the corporate group. If such companies wish to qualify as export trading companies as defined in the bill, they will need to do some exporting for, or provide trade services to, unaffiliated persons (generally, small and medium size U.S. firms). The bill does not establish minimum percentages for the proportion of export activity an export trading company must perform on behalf of unaffiliated persons; instead, the Federal agencies with administrative responsibilities related to the provisions of the bill are given flexibility to interpret and apply the definitions as seems most appropriate to further the purpose of the Act.

Because another principal objective of the Act is to induce major corporations with extensive export trade experience to offer exporting services to less experienced U.S. producers, it would be consistent with the Act to expect export trading companies to develop a significant portion of their total business in the export of goods or services produced by unaffiliated persons, or in the provision of export trade services to such persons. For example, a company claiming to be organized and operated principally as an export trading company within the definition in section 103(5) of the Act, but which over a reasonable period of years received on the average less than 10 percent of its gross sales or income through exporting goods for, or providing export services to, unaffiliated U.S. persons might be disqualified.

The bill also defines U.S. exports and establishes a presumption that the principal business of a U.S. export trading company should be U.S. exports. Export trade is defined to mean exports of goods produced in the United States or services provided by U.S. citizens or otherwise attributable to the United States. The bill requires that at least 50 percent of the value of such goods or services must be of U.S. origin in order for the goods and services to be considered U.S. exports for purposes of the Act. Fifty percent was chosen because it is the existing standard in the Internal Revenue Code for eligible "export receipts" of Domestic International Sales Corporations (DISCs). Setting a higher minimum threshold for U.S. content would not only create the legal anomaly that a sale could be an "export" for DISC purposes but not for meeting the definition of an export trading company, but could also unreasonably restrict the trade possibilities for companies seeking to qualify as export trading companies.

Section 103(5) defines an export trading company as one engaged "principally" in export trade, both on its own behalf and on behalf of unaffiliated persons. Thus, the presumption is established that on the average at least one-half the company's total business—which may include some domestic trade, some import trade and some "third-party" international trade wholly outside U.S. commerce—will be directly related to U.S. exports which must contain at least 50 percent value attributable to the U.S. If the company exports a product with 49 percent of the value added in the U.S., for example, the export sale counts as part of the "other" business of the company. not as part of its export business. Furthermore, successful trading companies must develop two- and three-way trade in order to reduce foreign exchange risk and maintain good relations with foreign customers. The presumption established in the Act will not be an easy one for trading companies to meet, but it does insure that "export trading companies" as defined in the Act will be principally and substantially engaged in exports of goods and services produced primarily by Americans.

The term "export trade services" is defined in section 103(4) of the Act to include a broad range of services provided in order to facilitate the export of goods or services produced in the United States. While the Act's purpose is to enable the performance by export trading companies of a wide range of services to expand U.S. exports, including transportation and forwarding, the bill is not intended to repeal or amend the provisions of the Shipping Act of 1916 (46 U.S.C. 800 et seq.), which govern the licensing of independent ocean freight forwarders. Export trading companies wishing to render forwarding services may do so upon qualifying for, and receiving, a license under that Act.

2. Promotion by Secretary of Commerce

The bill directs the Secretary of Commerce to promote and encourage the formation and operation of export trading companies by providing information and advice to interested persons and by facilitating contact between producers of exportable goods and services and firms offering export trade services. The provision is intended to lead to a better two-way referral system by the Department of Commerce. The Department has an established role in assisting companies interested in learning how to export and in acquiring foreign market information, but in many cases a more effective approach may be to put companies in contact with export trading companies or other private enterprises which can either provide export assistance or do the actual exporting. Conversely, as part of the Department's responsibility to promote export trading companies, it should help such companies and others providing export trade services to locate and contact U.S. producers of exportable goods and services. It is the Committee's view that the Commerce Department should be more responsive than it has been in the past to the needs of export management companies and international trade consultants to make contact with potential clients.

3. Ownership by Banks

This legislation seeks to stimulate a form of business activity in the United States which has been neglected by major corporations and investors and has consequently been deprived of significant financial resources, as the history of U.S. export management companies clearly demonstrates. In an economy which has been primarily oriented to the domestic market, it is not obvious where the investment and entreneurship can be found to establish export trading companies on an economical scale, and one which can also make a difference in the U.S. trade accounts. This legislation attempts to stimulate initiative from at least three possible sources: (1) accelerated internal growth by existing U.S. export management or export trading companies; (2) formation of independent export trading companies fostered by major corporations with international trade experience; and (3) investments by U.S. banking institutions in new or existing export trading companies.

Banks with international offices, experience in trade financing, business contacts abroad, international marketing knowledge, and familiarity with domestic U.S. producers are the most likely source of leadership in forming export trading companies. Their skills which are important to the organization and management of trading companies. A number of large non-Japanese trading companies are owned by banks in Europe. For example, Hongkong and Shanghai Banking Corp. owns a 33 percent controlling interest in Hutchinson Whampoa

Limited; Midland Bank Limited owns controlling interests in at least three trading companies; Barclay's Bank International owns 24.5 percent of Tozer, Kernsley and Millbourn; Credit Lyonnais owns 80 percent of Essor PME; and Banco de Brazil owns 100 percent of Beke Company.

The potential contribution of U.S. banks was explained by Erland Heginbotham, Deputy Assistant Secretary of State for East Asian and Pacific Affairs in testimony on March 18, 1980, before the International Finance Subcommittee: "The development of bank-owned trading companies promises to offer enormous potential for overcoming most of the major disadvantages now seriously inhibiting U.S. exports to Asia. A number of European banks now operate some of the largest European-owned trading companies . . . Banks bring not only assets but almost all of the supporting facilities and services which U.S. exporters now most lack by contrast with competitors. More importantly, banks can encourage and help exporters develop a longer-term view of, and presence in the market. Bank-affiliated trading companies would have special effect on encouraging more medium and small exporters who are now discouraged by the remoteness and strangeness of foreign markets and buyers, exchange risks, and by the complexity and expense of documentation."

Section 105 of the bill would permit U.S. banks to make limited investments in export trading ocmpanies, subject (except for non-controlling investments of less than $10 million) to the prior approval of Federal bank regulatory agencies, and subject to conditions and safeguards designed to ensure the safety and soundness of the banks and prevent favoritism in bank lending to a trading company in which it has an interest on the company's customers.

U.S. banks have been excluded from most commercial activities, including direct participation in export trade for more than a century. Among the reasons given for maintaining the traditional distinctions are: (1) that banks should focus on loans and deposits and can better exercise independent judgment on whether or not to make a loan if they are prohibited from holding a stake in the management of actual or potential borrowers; (2) that banks could be exposed to unfamiliar and excessive risks in commercial trading and the holding of inventories; (3) that the bank regulatory agencies lack the capacity to evaluate the commercial risks banks would encounter in owning export trading companies; (4) that bank capital is low and should be reserved for support of bank loans; and (5) that bank-owned export trading companies or companies dealing with them may have preferential access to bank credit.

A majority of the Committee members, while supporting the general principle of separation of banking and commerce, believes there is good and sufficient reason to make an exception on a controlled basis for limited and conditional bank ownership of export trading companies in order to strengthen the Nation's capacity to meet non-traditional international trade competition. The majority of the Committee members further believe that the bill as ordered reported contains prohibitions, restrictions, limitations, conditions and requirements more than ample to meet each of the concerns raised with respect to bank ownership of export trading companies:

(1) The bill prohibits banks from making loans to any export trading company in which the bank holds any interest whatsoever, and to

any customers of such company, "on terms more favorable than those afforded similar borrowers in similar circumstances" or involving "more than the normal risk of repayment" or presenting "other unfavorable features". Thus, banks would be barred from making preferential or unusually risky loans to export trading companies or their customers.

(2) The bill prohibits banking organizations from owning any interest in any export trading company which "takes positions in commodities or commodities contracts other than as may be necessary in the course of its business operations." That is, speculation in commodities is forbidden for any trading company controlled by a banking organization.

(3) The bill empowers the Federal financial institutions regulatory agencies (the Federal Reserve Board, the Comproller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board for Federal savings banks) when acting on a bank's application to take to take a controlling interest in an export trading company, to impose any conditions they deem necessary

> (A) to limit a banking organization's financial exposure to an export trading company, or (B) to prevent possible conflicts of interest or unsafe or unsound banking practices.

(4) The bill directs the Federal financial institutions regulatory agencies to establish standards with respect to the taking of title to goods by any export trading company subsidiary of a banking organization, standards "designed to ensure against any unsafe or unsound practices that could adversely affect a controlling banking organization investor, including specifically practices pertaining to an export trading company subsidiary's holding of title to inventory." Any changes in the trading company's practices with respect to taking title would have to be approved in advance by the Federal agency.

(5) The bill would bar any banking organization from taking a controlling interest or making any investment over $10 million in any export trading company without receiving the prior approval of the appropriate Federal financial institutions regulatory agency. The Federal agency would be required to disapprove any application for which it finds

> That the export benefits of such proposal are outweighed in the public interest by any adverse financial, managerial, competitive, or other banking factors associated with the particular investment.

(6) The bill would prohibit aggregate investments by any banking organization of more than 5 percent of its consolidated capital and surplus in one or more export trading companies.

(7) The bill would prohibit the total of a banking organization's historical direct and indirect investments in a trading company and loans to such company and its subsidiaries from exceeding 10 percent of the bank's capital and surplus.

(8) The bill would allow the appropriate Federal agency

> Whenever it has reasonable cause to believe that the ownership or control of any investment in an export trading company constitutes a serious risk to the financial safety, soundness, or stability of the banking organization and is incon-

sistent with sound banking principles or with the purposes of this Act or with the Financial Institutions Supervisory Act of 1966, order the banking organization . . . to terminate . . . its investment in the export trading company.

The majority of the Committee are supported in their view that the bill contains appropriate Federal regulatory authority over bank investments in export trading companies by the Administration, by the Comptroller of the Currency, and (with one exception) by the Federal Reserve Board. For the views of the agencies, see the letters in the Appendixes to this report. The sole exception is the Board's view that Federal bank regulatory agencies should not be authorized to approve any controlling investments by banks in export trading companies. Specifically, the Board would prohibit any one banking organization from acquiring more than 20 percent of export trading companies and any group of banking organizations from acquiring more than 50 percent of a trading company. The Board would accept non-controlling investments, subject to the provisions contained in the bill. The Board appears to question the ability, as well as the propriety, of permitting banks, either singly or as a group to manage export trading companies.

The Bankers' Association for Foreign Trade, in testimony before the Subcommittee on International Finance on March 18, 1980, stressed the importance of flexibility with respect to the types of permissible bank investments in export trading companies:

> Because the trading company concept is new to the United States, it is difficult for me to indicate at this time the precise ways banking organizations may choose to participate. Some banking organizations may want to finance export trading companies and their customers but not take an equity position; others are more interested in investing in export trade service firms than export trading companies; and others are interested in investing in export trading companies, but may differ on the scope of participation they may find appropriate *e.g.*, some are interested in joint ventures and others are interested in forming their own subsidiaries. Given this diversity of interest, we support S. 2379's flexible approach and would thus recommend against foreclosing any options at the present time because trading companies must and will evolve in response to market forces, and banking organization involvement will be controlled through the existing bank regulatory framework.

James B. Sommers, Executive Vice President of North Carolina National Bank, testified that banks might wish to organize export trading companies to put together large "turnkey" export projects, e.g., the construction of a plant in a developing country. Such companies will most likely be regional trading companies involving more than one banking organization. E. Anthony Newton, Senior Vice President of Philadelphia National Bank, testified that his bank has an overseas financing subsidiary which could be a more effective competitor in the Far East if it could take title to goods—an activity it safely engaged in before acquisition by Philadelphia National Bank. The Federal Reserve Board would have the Congress deny it the authority to approve such investments and activities by U.S. banks. For example, even a trading company organized by banking organizations for a single project overseas would be prohibited.

Permitting banking organizations to take controlling interests in trading companies promotes the safety and soundness of the investing banking organization, since it gives them greater ability to protect their investment through control of the business operations of an export trading company. A banking organization is more likely to become involved in an export trading company if it has a substantial or controlling voice in management. Arbitrary statutory limits on controlling investments serve only to lock banking organizations out of a management roll; increase the risks of their investment, and deny to trading companies their substantial international expertise. The regulatory controls included in the bill insure that the greater degree of bank control, the greater degree of bank regulatory agency control. The Committee believes this flexible approach adopted in the bill is necessary to encourage effective bank participation. Without initiatives by U.S. banks, the effort to stimulate U.S. export trading companies would be seriously weakened.

The amounts of bank capital potentially involved and the risks to the banks must be put into perspective based on the restrictions in the bill. Total capital of all the banks in the United States is about $98 billion. Because the bill limits aggregate investments to 5 percent of capital, if every bank in the country from the smallest to the largest were allowed by the Federal regulators to invest the maximum amount under the Act, the total investment allowed would be $4.9 billion. Because the bill limits the total of investments and loans in export trading companies to 10 percent of capital, if every bank in the country both invested and lent the maximum under the Act, the total of all investments and loans would be $9.8 billion. Realistically, only a small fraction of U.S. banks, large and small, will invest in, or lend to, an export trading company.

Both the banks and the Federal bank regulatory agencies can be expected to proceed cautiously. At most, $1 billion in total bank investments and loans to export trading companies might be anticipated within 5 years after enactment. In an economy which has long passed the $1 trillion mark, such amounts seem unlikely to dry up credit or significantly affect bank capital. Investments in export trading companies should strengthen bank capital by earning profits and diversifying risks. The 10 percent limit on combined investments and loan is quite conservative, considering that state banks in several states, including New York, may lend up to 25 percent of capital to a single borrower, and that some banks have more than half of their capital exposed in loans to borrowers in a single developing country.

In considering individual applications or notifications, the appropriate Federal agency may determine that safeguards are needed to protect against certain activities or practices which could reflect adversely on the banking organization investor. For example, the agencies may want to prohibit an ETC owned by a banking organization from engaging in manufacturing operations or owning other commercial concerns. They may also want to set conditions designed to insure that a bank-owned ETC is run in a financially-sound manner in order to safeguard the reputation and integrity of the banking organization investor.

Conditions appropriate to an ETC wholly-owned or controlled by a banking organization may be wholly inappropriate where a banking organization is to be a non-controlling investor. The size of the banking organization and ETC, the degree of banking organization involvement, and the size and financial strength of other participants are all factors that need to be weighed. Conditions imposed by the Federal banking agencies should not unnecessarily disadvantage, restrict or limit bank-owned ETCs in competing in world markets or achieving the purposes of section 102 of the Act. Conditions thus should be carefully drawn to meet legitimate concerns, without unduly handicapping bank-owned ETCs in meeting foreign competition. The Committee strongly believes that such conditions should not serve to discourage involvement of banking organizations, but rather should encourage their participation in the most prudent manner.

4. Initial Investments and Operating Expenses

The bill provides in section 106 for greater support by the Economic Development Administration (EDA) and the Small Business Administration (SBA) for the formation and expansion of export trading companies. Both agencies have given some support to export-related activities in the recent past, but only in minimal amounts. The Assistant Secretary of Commerce for Trade Development, Herta Lande Seidman, testified before the International Finance Subcommittee on April 28, 1980:

> Through the facilities of the Economic Development Administration, the Commerce Department is in a position to make loans and grants to meet the combined objectives of job creation and export promotion. In 1979, for example, EDA funding of export-related efforts amounted to $6.7 million in loans and $2.5 million in grants. These funds supported, among other efforts, an extensive textile, apparel, and footwear export expansion drive and promotion projects of the New York/New Jersey Port Authority. We in the International Trade Administration are working closely with EDA to develop grant- and loan-making procedures to ensure that the export programs funded by EDA are closely meshed with Trade Development activities in ITA. EDA is prepared in 1980 to supply a somewhat larger amount in grants and a significantly larger amount in loans for trade facilitation programs through its trade adjustment assistance, distressed area and other programs. Similar levels of activity are feasible in the future if funding for those programs continues. EDA, depending on its resources, is interested in giving continuing support to export-related programs.

The Small Business Administration, according to President Carter's Export Policy statement of September 26, 1978 was to provide up to $100 million in assistance to small businesses getting started in exporting. Less than $5 million has actually been used by SBA for this purpose, and SBA is widely charged with lack of interest and expertise in export development.

S. 2379 would have provided a $100 million, five-year facility in the Export-Import Bank to assist the formation of export trading companies by providing loans on a matching basis of not more than $1 million per year or $2.5 million in total to applicants to assist with initial investments and operating expenses associated with launching an export trading company. The assistance would only have been available where private credit was inadequate and other criteria were met. Because the Export-Import Bank and the Administration opposed lodging the program in the Bank, the present legislation vests responsibility in EDA and SBA to help export trading companies meet start-up costs.

Section 106(a) would direct EDA and SBA, when considering loan or guarantee applications from export trading companies, to give "special weight to export-related benefits, including opening new markets for United States goods and services abroad and encouraging the involvement of small or medium-size businesses or agricultural concerns in the export market." The purpose of the amendment is to encourage EDA and SBA to consider favorably those applications with export benefits which also meet other criteria which EDA and SBA are required to consider. The provision is not intended to override or dilute other considerations the agencies are required to take into account.

Section 106(b) would authorize appropriation of an additional $20 million per year in fiscal years 1981 through 1985 to either EDA or SBA to support loans (or guarantees, if necessary) provided to meet the purposes of section 106(a). If existing authorizations and appropriations thereunder are deemed adequate by the Appropriations Committees of the Congress to meet the purposes of section 106(a), the authority of section 106(b) would not be used.

5. Guarantees by Export-Import Bank

Section 107 authorizes and directs Eximbank to establish a guarantee program for commercial loans to U.S. exporters secured by export accounts receivable or inventories of exportable goods, when in the judgment of the Board of Directors:

1. Private credit is inadequate to enable otherwise credit-worthy exporters to complete export transactions, and
2. Such guarantees would facilitate exports which would not otherwise occur.

The Administration did not object to guarantees in support of loans against export accounts receivable, but contended that inventories are adequately financed by the private sector. The amendment takes the Administration's view into account by permitting the guarantee program to operate only to the extent that the Board of Directors determines the private credit market is not providing adequate financing. It is the intent of the Committee that the guarantees be directed primarily toward securing credit for small exporters. The amounts of guarantees would be limited by limits set in annual appropriations Acts.

TITLE II—EXPORT TRADE ASSOCIATIONS

Under the Export Trade Act of 1918, commonly known as the Webb-Pomerene Act (15 U.S.C. 61–65), the joint exporting activities of export trade associations (associations engaged solely in export trade) receive a limited exemption from the Sherman and Clayton Antitrust Acts.

66-942 O - 80 - 20

The Webb-Pomerene Act was an outgrowth of a report on foreign trade activities affecting U.S. companies prepared by the Federal Trade Commission in 1916. The Commission's report found that American manufacturers and producers were disadvantaged in attempting to enter foreign markets individually because of strong combinations of foreign competitors and organized buyers. The report concluded that in order for small American producers and manufacturers to enter world markets on a profitable basis and on more equal terms with these foreign combinations, they should be permitted to cooperate in their exporting efforts without fear of prosecution under the antitrust laws.

Section 2 of the Webb Act exempts from the Sherman Act (which prohibits contracts, combinations, or conspiracies in restraint of trade occurring either in interstate commerce or in commerce with foreign nations) an association entered into for the sole purpose of engaging in export trade as long as the association, its acts, or any agreements into which the association enters do not: (1) restrain trade within the United States; (2) restrain the export trade of any domestic competitor of the association; or (3) artificially or intentionally influence prices within the United States of commodities of the class exported by the association. The Act also provides for oversight of Webb-Pomerene associations by the Federal Trade Commission.

Between 1930 and 1935 Webb-Pomerene associations numbered 57 and accounted for approximately 19 percent of total U.S. exports. By 1979 the number of associations had dwindled to 33 and their share of total U.S. exports had dipped to less than 2 percent.

The reasons for this poor showing are many. First, the vast majority of the 250 or so Webb-Pomerene associations formed over the last 60 years lacked sufficient product-market domination to exert foreign market price control and membership discipline. Second, the business community traditionally has placed top priority on tapping the vast domestic market and has been much slower to focus on the prospects overseas. Third, the ever expanding U.S. service industries have been excluded from qualifying for the Act's antitrust exemption, while cooperative and joint ventures have become increasingly important in the exportation of services. Fourth, and perhaps most important, the Department of Justice, and to a lesser extent the Federal Trade Commission, have been perceived by the business community as exhibiting a thinly veiled hostility toward Webb-Pomerene associations. The vagueness of the Webb-Pomerene Act leaves uncertain what activities will constitute a substantial restraint of domestic trade. As a result, the threat of antitrust litigation has served as a deterrent to broader utilization of the Webb-Pomerene Act.

With the increasing emphasis on the need to improve the competitiveness of U.S. companies in the world marketplace has come an awareness of the need to reduce the domestic barriers to exports. The provisions of this bill are intended as a step toward that goal. At the same time, however, the bill contains numerous procedural and substantive safeguards to ensure that this goal is not achieved at the cost of violating traditional principles of U.S. antitrust law.

6. Antitrust Exemption for Certified Export Trade Activities

Title II does the following: First. It makes the provisions of the Webb-Pomerene Act explicitly applicable to the exportation of services (the National Commission for the Review of Antitrust Laws and

Procedures made this same recommendation in its report to the President in January 1979);

Second. It expands and clarifies the Act's antitrust exemption for export trade associations and export trading companies;

Third. It requires that the antitrust immunity be made contingent upon a certification procedure and in conformance with existing standards of antitrust law;

Fourth. It transfers the administration of the Act from the Federal Trade Commission to the Department of Commerce;

Fifth. It provides for procedures whereby the Justice Department and the Federal Trade Commission can provide their advice to the Department of Commerce during the certification process, and can seek invalidation of any certification which fails to conform to the substantive standards of the Act;

Sixth. It creates within the Department of Commerce an office to promote the formation of export trade associations and export trading companies; and

Seventh. It provides for the establishment of a task force whose purpose will be to evaluate the effectiveness of the Webb-Pomerene Act in increasing U.S. exports and to make recommendations regarding its future to the President.

Title II reflects a recognition of the significant contribution to the promotion of U.S. export trade which can be made by export trade associations and export trading companies if they are allowed to engage in specific joint activities without fear of prosecution under the antitrust laws. Title II provides immunity from the application of U.S. antitrust laws for specified export trade, export trade activities and methods of operation of export trade associations and export trading companies only when: 1) the proposed export activities are determined not to be in violation of specified antitrust standards; 2) there is an established need for the immunity; and 3) the association or company successfully completes the certification process required in the bill.

7. Certification procedures

The certification process mandates that the Department of Commerce, after consulting with the Justice Department and the Federal Trade Commission, determine that the export trade activities of the association or company violate none of the substantive standards of antitrust law set forth in Section 204(a) of the bill. That Section, which amends the second and fourth sections of the Webb-Pomerene Act (15 U.S.C. 62 and 64), sets out eligibility criteria for the antitrust exemption afforded under the Act for export trade associations and trading companies.

With the exception of the requirements in paragraphs (1) and (6) of Section 204—provisions that impose further criteria for eligibility in addition to those found in the standards of the current Webb-Pomerene Act—the substantive law of antitrust as modified by the Webb-Pomerene Act has not been altered. As the court stated in *United States* v. *Minnesota Mining and Manufacturing Company*, 92 F. Supp. 947 at 965 (D. Mass. 1950):

> Now it may very well be that every successful export company does inevitably affect adversely the foreign commerce of those not in the joint enterprise and does bring the

> members of the enterprise so closely together as to affect adversely the members' competition in domestic commerce. Thus every export company may be a restraint. But if there are only these inevitably consequences an export association is not an unlawful restraint. The Webb-Pomerene Act is an expression of Congressional will that such a restraint shall be permitted.

The amendment of the Webb-Pomerene Act by Section 204(a) of Title II, with the exceptions as noted above, is a codification of court interpretations of the Webb-Pomerene exemption to domestic antitrust law. Further, the amendment is consistent with the enforcement policy of the Department of Justice. As stated by Ky Ewing, Deputy Assistant Attorney General, Antitrust Division, Justice Department, during hearings on S. 864 (now Title II) before the International Finance Subcommittee:

> We note (that S. 864) would require that a restraint of U.S. domestic trade be substantial before the exemption would disappear. The purpose of this proposal . . . is to bring the act into what we conceive to be the current state of antitrust law interpreted by the court. (September 17, 18th hearing record on Export Trading and Trade Associations, p. 138)

Similarly, Daniel Schwartz, Deputy Director, Bureau of Competition, Federal Trade Commission, testified that the antitrust standards specified in S. 864 "are essentially equivalent to the standards of the Webb-Pomerene Act." (Id. at p. 194).

In his prepared statement, Mr. Ewing further explained that:

> The judicially accepted legal threshold test for applicability of the Sherman Act to activity abroad places a heavier burden on government and private plaintiffs than that applicable domestically. The presence of a substantial and foreseeable effect on U.S. domestic or foreign commerce is required, not merely some minimal effect. (Id. at 144).

Mr. Ewing also noted in his testimony before the Subcommittee that:

> The Department of Justice has long predicated its enforcement efforts in export related matters upon the ability to prove a substantial and foreseeable effect on U.S. commerce. (Id. at pp. 154–155)

This interpretation of existing antitrust law was confirmed by Sanford Litvack, Assistant to Attorney General, Antitrust Division. In a letter to Senator Proxmire, Chairman of the Committee on Banking, Housing, and Urban Affairs, Mr. Litvack noted that certain activities undertaken by exporters "may well not violate the Sherman Act in any event *due to their lack of substantial effect on U.S. trade or commerce.*" (emphasis supplied)

These interpretations of existing antitrust law are consistent with long standing policy. For example, the 1955 Report of the Attorney General's Antitrust Committee stated:

> We feel that the Sherman Act applies only to those arrangements between Americans alone, or in concert with foreign firms, which have such substantial anticompetitive effects on this country's trade or commerce * * * with foreign nations' as to constitute unreasonable restraints. (Report, supra at pp. 76–77).

The bill also adds two new substantive standards, requested by the Department of Justice, to the Webb-Pomerene Act—a requirement that the export trade must not constitute trade or commerce in the licensing of patents, technology, trademarks or know-how, and that the export activities must serve to preserve or promote export trade.

Before an association or export trading company can obtain certification, the Secretary of Commerce also must find that the export activities to be certified will serve a specified need. Only those export trade, export trade activities and methods of operation specified in the certification issued by the Secretary of Commerce are immunized. The certification must include any terms or conditions deemed necessary by the Secretary, in consultation with the Department of Justice and the Federal Trade Commission, in order to bring the company or its export activities into compliance with any of the substantive standards. Any material change in the export trade, export trade activities or methods of operation must be reported to the Secretary and any modification to the certification must be approved by the Secretary. The guidelines to be used in making these determinations are to be issued by the Secretary of Commerce, after consultation with the Attorney General and the Federal Trade Commission.

8. Amendment, Revocation or Invalidation

Even after the export activities of an association or export trading company have been certified, they remain subject to the continuing scrutiny of the Department of Commerce and Justice and the Federal Trade Commission. The certification of any association or export trading company whose activities fail to comply with any of the substantive standards is subject to modification or revocation by the Department of Commerce. Additionally, either the Department of Justice or the Federal Trade Commission at any time may initiate an action to invalidate all or any part of the certification of an association or trading company. Once the certification has been revoked, civil or criminal actions and enforcement proceedings may be brought on a prospective basis.

TITLE III—TAXATION OF EXPORT TRADING COMPANIES

9. Application of DISC Rules

The tax provisions have two purposes: (1) to enable export trading companies to use DISC with respect to all their income from exports of services as well as products; and (2) to permit small, closely held companies to use Subchapter S to pass through net losses in the first few years when start-up costs are likely to exceed income. If there is any significant revenue loss directly attributable to the tax provisions, it will be because export trading companies succeed in significantly expanding U.S. exports, which means additional revenue is being produced through additional exports.

Section 301 would provide that gross receipts of an export trading company from "export trade services" as well as the export of "services produced in the United States," as defined in the Act, are eligible DISC receipts. The purpose of the provision is to avoid forcing export trading companies to segregate artificially certain services in order to enjoy DISC status for the receipts from such services.

This section would also require the Assistant Secretary of Commerce, with the cooperation and assistance of the Director of the Internal Revenue Service to disseminate information to exporter and export trading companies on how to form and use DISCs.

The Treasury Department computed the potential revenue cost of extending DISC benefits to "services produced in the United States" at $740 million for 1978. Acknowledging the difficulties of computing the actual revenue cost, this figure was reduced to a "more conservative estimate of $200–500 million." Similarly, Treasury noted that the potential revenue cost of extending DISC benefits to "export trade services" as $200 million, reduced to "a conservative ball park estimate of $100–200 million."

However, Treasury's computations were based on the premise that DISC benefits would be extended to the services produced in the U.S. or the export trade services of all DISC's. The bill extends DISC treatment of these services only to DISCs which are export trading companies. Thus, to the extent Treasury's estimates are based on income from DISC's which would not qualify as export trading companies, the estimates necessarily overstate the actual revenue costs. Since most DISC's are exporting, either solely or principally, the goods or services of a parent or affiliate, the number of present DISC's which would qualify as export trading companies is likely to be relatively small.

10. Subchapter S Status

Section 302 would amend Subchapter S of the Tax Code to permit an export trading company to use the provisions of that subchapter without limiting the foreign source income of such company to less than 20 percent per annum. Some export trading companies might have difficulty complying with the existing statutory restriction. Section 302 would also permit shareholders in companies eligible to use subchapter S to be not more than 15 individuals or companies, if the companies are each owned by not more than 15 individuals.

SECTION-BY-SECTION ANALYSIS OF THE BILL

TITLE I—EXPORT TRADING COMPANIES

Short Title

Section 101 provides that Title I may be cited as the "Export Trading Company Act of 1980."

Findings

Section 102 includes eight findings by Congress concerning exports and export trading companies, and states that the purpose of the Act is to increase U.S. exports by encouraging more efficient provision of export trade services to U.S. producers.

Definitions

Section 103 defines the following terms used in the title: "export trade," "goods produced in the United States," "services produced in the United States," "export trade services," "export trading company," "United States," "Secretary," and "company." An export trading company is defined as a U.S. company "organized and operated principally for the purposes of (A) exporting goods or services produced in the United States; and (B) facilitating the exportation of goods and services produced in the United States by unaffiliated persons by providing one or more export trade services."

Promotion of Export Trading Companies by Secretary of Commerce

Section 104 requires the Secretary to promote and encourage formation and operation of export trading companies by providing information and advice to interested persons and by facilitating contact between producers and firms offering export trade services.

Definitions in Section on Bank Ownership

Section 105(a) defines "banking organization," "State bank," "State member bank," "State nonmember insured bank," "bankers' bank," "bank holding company," "Edge Act Corporation," "Agreement Corporation," "appropriate Federal banking agency," "capital and surplus," "affiliate," "control," "subsidiary," and "export trading company." The terms "control" and "subsidiary" are defined as in the Bank Holding Company Act. The term "export trading company" means an export trading company as defined in sec. 103(5) or a company organized and operated principally for the purpose of providing export trade services.

Authority to Own Export Trading Companies

Section 105(b)(1) would authorize banking organizations, subject to the procedures and limitations of section 105 (b) and (c) to invest in the aggregate not more than 5 percent of the banking organizations consolidated capital and surplus in export trading companies.

Section 105(b)(1)(A) would authorize investments of up to $10 million in total by a banking organization without prior approval by the appropriate Federal banking agency if such investment did not make the export trading company a subsidiary of the banking organization (Pursuant to the Bank Holding Company Act, ownership of 25 percent of the stock is presumed to constitute control and therefore make the company a subsidiary, and ownership of less than 25 percent may be found by the Federal banking agency to constitute control and make the company a subsidiary. If the agency made such finding it could require divestiture or place conditions on the investment.). Section 105(b)(1)(B) would permit investments of more than $10 million, or controlling investments, or investments which give a group of banking organizations more than 50 percent of the stock of an export trading company, only with prior approval of the appropriate Federal banking agency.

Section 105(b)(2) would require banking organizations to notify the appropriate Federal banking agency 60 days before making any additional investment in an export trading company subsidiary or engaging in any line of activity, including specifically the taking of title to goods, which was not previously disclosed. The Federal banking agency could disapprove or place conditions on such investment or activity.

Section 105(b)(3) would provide that if the appropriate Federal banking agency failed to act upon an application or notification within the specified time period, approval would be assumed.

Additional Limitations on Bank Investments in Export Trading Companies and on Such Companies

Section 105(c) would place the following limitations on export trading companies and investments in them by banking organizations: (1) the export trading company could not use a name similar to that of any banking organization owning any of its stock; (2) the total historical cost of a banking organization's direct and indirect investments in an export trading company, plus any credit extended by the organization and its subsidiaries to the company, could not exceed 10 percent of the banking organization's capital and surplus; (3) banking organizations could not hold stock in export trading companies which take speculative positions in commodities; and (4) banking organizations could not extend credit to any export trading company in which it holds stock, or to the company's customers, on terms "more favorable than those afforded similar borrowers in similar circumstances, and such extension of credit shall not involve more than the normal risk of repayment or present other unfavorable features."

Factors to be considered by Federal Banking Agencies in Disapproving or Placing Conditions on Investments

Section 105(d) would require the appropriate Federal banking agency to consider the resources, competitive situation, and future prospects of the banking organization and export trading company concerned in any application, and the effect on United States competitiveness in world markets, and authorize the agency to disapprove the investment if it finds the export benefits are "outweighed in the public interest by adverse financial, managerial, competitive, or other banking factors." The agency would be authorized to impose such conditions on approved investments or activities as it deemed necessary" (A) to limit a banking organization's financial exposure to an export trading company, or (b) to prevent possible conflicts of interest or unsafe or unsound banking practices." The agency would be required to set standards for the taking of title to goods and holding of inventory to prevent unsafe or unsound practices. In imposing conditions, the Federal banking agency would be required to consider the size of the banking organization and export trading company involved, the degree of investment or other support to be provided by the banking organization, and identity and financial strength of other investors. The agency could not impose conditions on the taking of title which unnecessarily disadvantage, restrict or limit trading companies in competing in world markets. Not withstanding any other provision, the appropriate Federal banking agency could after due notice and opportunity for hearing, order an investment in an export trading company terminated if the agency had reasonable cause to believe the investment constituted a serious risk to the banking organization or was inconsistent with sound banking principles or the Financial Institutions Supervisory Act of 1966. Within two years after enactment a report to Congress by the Federal banking agencies would be required.

Court Appeals

Section 105(e) would provide an opportunity to appeal orders of Federal banking agencies to the Federal Court of Appeals and require cases of procedural error to be remanded to the agency and permit cases of substantive error to be remanded to the agency as well.

Rulemaking and Enforcement

Section 105(f) would provide general rulemaking authority to Federal banking agencies for purposes of administering this section.

Initial Investments and Operating Expenses

Section 106 would direct EDA and SBA to give special weight to export benefits, including opening new export markets and encouraging exporting by small and medium-size businesses or agricultural concerns, when considering applications by export trading companies for loans and guarantees. $20 million would be authorized to be appropriated for each of the next 5 fiscal years for the purposes of this section.

Guarantees for Export Accounts Receivable and Inventory

Section 107 would direct the Export-Import Bank to establish a guarantee program for commercial loans secured by export accounts receivable or inventories of exportable goods when the Bank's Board judged the private credit market was not providing adequate export financing to otherwise creditworthy exporters and such guarantees would facilitate exports which would not otherwise occur. The guarantees would be subject to limits in annual appropriation Acts.

TITLE II—EXPORT TRADE ASSOCIATIONS

Section 201. Short Title: Export Trade Association Act of 1980

Finding and Declaration of Purposes

Section 202 sets forth findings by the Congress regarding exports and joint exporting activities and the purposes of the Act.

Definitions

Section 203 defines the pertinent terms. The definition of "export trade" is expanded from the definition contained in the Webb-Pomerene Act (15 U.S.C. 61–66) to include services. The term "service" means intangible economic output, including, but not limited to business, repair, and amusement services; management, legal, engineering, architectural, and other professional services; and financial, insurance, transportation, and communication services. The term "export trade activities" includes any activities or agreements in the course of export trade. The term "association" refers to any combination of persons, partnerships, or corporations, all of which must be citizens of the United States or created under the laws of any State or of the United States. A foreign controlled subsidiary created under the laws of any State or of the United States, however, cannot be a member of the "association." The term "antitrust laws" means the antitrust laws defined in the first Section of the Clayton Act and Section 4 of the Federal Trade Commission Act.

Exemption from Antitrust Law

Section 204 strikes Sections 2 and 4 of the Webb-Pomerene Act and inserts in lieu thereof a new Section 2. Section 2 provides that an export trade association or export trading company and their members, certified according to the procedures set forth in this Act is exempt from the application of the antitrust laws during the period of the certification provided that the association or export trading company and its export trade activities (1) serve to preserve or promote export trade: (2) neither result in a substantial lessening of competition or substantial restrain of trade within the United States nor constitute a substantial restraint of the export trade of any competitor of the association: (3) do not unreasonably enhance, stabilize, or depress prices within the United States; (4) do not constitute unfair methods of competition against competitors engaged in export trade; (5) are not reasonably expected to result in the consumption or resale in the United States of goods or services exported by the association or export trading company; and (6) do not constitute trade or commerce in the licensing of patents, technology, trademarks, or know-how, except as incidental to the sale of goods or services exported by the association or export trading company or its members.

Section 2 also provides for a 30 day suspension of the effective date of the exemption if the Attorney General or the Federal Trade Commission formally advises the Secretary of Commerce that it disagrees with the Secretary's determination to issue a certification.

Section 205. Conforming Changes in Style Section 205 amends Section 3 of the Webb-Pomerene Act to provide for conforming change in style.

Administraton; Enforcement; Reports

Section 206 strikes Section 5 from the Webb-Pomerene Act and inserts in lieu thereof a new Section 4 and eight additional new sections.

A new Section 4(a) establishes the procedure for applying for certification as an export trade association or export trading company. It requires associations or export trading companies seeking certification to file applications describing in detail their proposed export activities including the goods or services to be exported, the methods of export trade, including, but not limited to, any agreements to sell exclusively to or through the association, any agreements with foreign persons who may act as joint selling agents, any agreements to acquire a foreign selling agent, any agreements for pooling tangible or intangible property or resources, or any territorial, price-maintenance, membership, or other restrictions to be imposed upon members of the association or export trading company, and any other information the Secretary may request on the association or company, its relations with other associations or companies, and effects on competition or potential competition.

A new Section 4(b) requires the Secretary to certify an association or export trading company within 90 days after receiving the application if the Secretary determines, after consultation with the Attorney General and Federal Trade Commission, that the proposed trade activities and methods of operation meet the standards set forth in amended Section 2 of the Act and will serve a specified need in promoting export trade. The certificate must specify permissible activities and any terms and conditions deemed necessary to ensure that the standards of the Act are met. Expedited certification and appeals procedures are specified.

This Section also requires the Secretary to provide the Attorney General and the Federal Trade Commission with a copy of the proposed certificate and sets forth procedures to be followed by the Attorney General and the Commission in rendering advice on a certification. Certifications may be issued by the Secretary prior to the expiration of forty-five days after the proposed certification has been delivered to the Attorney General or the Commission only if no formal notice of disagreement has been made by the Attorney General or Commission under the procedures specified in the Act.

A new Section 4(c) of the Webb-Pomerene Act requires certified export trade associations and export trading companies to report any material changes in membership, export trade, export trade activities and methods of operations and allows them to apply for an amended certificate. There is no interruption in the certification period for applications made within 30 days of the change and approved by the Secretary.

A new Section 4(d) of the Act permits the Secretary to require certified export trade associations or export trading companies to modify their organization or operation to correspond with their certification, or to revoke or amend the certification.

A new Section 4(e) to the Webb-Pomerene Act authorizes the Attorney General or Federal Trade Commission to bring an action to invalidate, in whole or in part, a certification on the grounds that the export trade, export trade activities or methods of operation of an export trade association or export trading company fail to meet the standards of Section 2 of the Act. This Section also permits the Attorney General or Commission to seek preliminary relief pending the disposition of an action if the Attorney General or Commission brings an action for invalidation the 30 day period provided in Section 2(b)(2). No person other than the Attorney General or the Commission would have standing to bring an action against an association or company for failure to meet the standards of Section 2 of the Act.

A new Section 5 to the Webb-Pomerene Act requires that the Secretary, the Attorney General, and the Chairman establish guidelines for purposes of determining whether an association, its members and its export trade activities meet the requirements of the new Section 3.

A new Section 6 to the Webb-Pomerene Act stipulates that every certified association or export trading company shall submit to the Secretary an annual report setting forth the information required in the application for certification.

A new Section 7 to the Webb-Pomerene Act establishes within the Department of Commerce an office to promote and encourage to the greatest extent feasible for formation of export trade associations through the use of provisions of this Act.

A new Section 8 to the Webb-Pomerene Act provides for automatic certification for existing export trade association registered under current law. In order to obtain automatic certification, an existing export trade association must file and application for certification with 180 days after the date of enactment of this Act.

A new Section 9 to the Webb-Pomerene Act provides for the confidentiality of the information contained in an association's application for certification, application for amendment of certification, and annual report.

Section 9 also requires the Secretary to make available to the Attorney General and the Commission for their official use all materials filed by an association or export trading company which has been certified or. which has applied for certification if the Secretary believes the applicant is eligible for certification.

A new Section 10 to the Webb-Pomerene Act authorizes the Secretary of the Treasury to require an association or export trading company to modify its operations so as to be consistent with future international obligations of the United States set by treaty or statute.

A new Section 11 to the Webb-Pomerene Act authorizes the Secretary, in consultation with the Attorney General and the Chairman, to promulgate such rules and regulations as are necessary to carry out the purposes of this Act.

A new Section 12 to the Webb-Pomerene Act requires the President seven years after the date of enactment of this Act to appoint a task force to examine the effect of the operation of this Act on domestic competition and on the United States' international trade deficit and to recommend either continuation, revision, or termination of the Webb-Pomerene Act.

Section 6 of the Webb-Pomerene Act is redesignated as "Section 14. Short Title".

TITLE III: TAXATION OF EXPORT TRADING COMPANIES

DISC

Section 301 would amend the provisions of The Internal Revenue Code concerning Domestic International Sales Corporations (DISCs) in order to: (a) insure that bank investments in export trading companies would not disqualify such companies from using DISCs; (b) make receipts from exports of services or export trade services eligible DISC receipts, that is, eligible for partial deferral of income taxation: and (c) require the Secretary of Commerce in consultation with the Secretary of the Treasury to prepare and distribute information on how export trading companies could use DISC status and the likely advantages or disadvantages of doing so.

Subchapter S

Section 302 would amend provisions of subchapter S of the Internal Revenue Code which permit closely held corporations (15 or fewer individual shareholders) to pass through certain losses or income to shareholders. The amendments would exclude export trading companies from the requirement that 20 percent of the annual income of a subchapter S corporation be domestic income, and permit an export trading company to qualify for subchapter S if owned by shareholders which were small business corporations as defined in subchapter S authorizing in effect a second-stage subchapter S corporation.

FISCAL IMPACT STATEMENT

In accordance with section 252(a) of the Legislative Reorganization Act of 1970, the Committee estimates the bill will result in additional outlays during fiscal year 1981 of $15,000,000. This concurs with the estimate prepared by the Congressional Budget Office, which follows:

25

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., May 15, 1980.

Hon. WILLIAM PROXMIRE,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Pursuant to Section 403 of the Congressional Budget Act of 1974, the Congressional Budget Office has prepared the attached cost estimate for a bill to encourage exports by facilitating the formation and operation of export trading companies, export trade associations, and the expansion of export trade services generally, as ordered reported on May 12, 1980.

Should the Committee so desire, we would be pleased to provide further detail on the attached cost estimate.

Sincerely,

ALICE M. RIVLIN,
Director.

CONGRESSIONAL BUDGET OFFICE—COST ESTIMATE

1. Bill number: Not Yet Assigned.
2. Bill title: A bill to encourage exports by facilitating the formation and operation of export trading companies, export trade associations, and the expansion of export trade services generally.
3. Bill status: Committee Print No. 2 as ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on May 12, 1980.
4. Bill purpose: The purpose of Title I is to encourage more efficient provision of export trade services to American producers and suppliers. Section 106 directs the Economic Development Administration and the Small Business Administration to give special weight to export-related benefits when considering loan and guarantee applications by export trading companies. In addition, it authorizes the annual appropriation of $20 million for fiscal years 1981 through 1985 for this purpose. Section 107 directs the Export-Import Bank to establish a program to provide loan guarantees to export trading companies. These loan guarantees are subject to the limitations provided in the annual appropriation acts.

Title II applies the Webb-Pomerene Act to the exportation of services and transfers the Administration of that Act from the Federal Trade Commission to the Secretary of Commerce. Section 205 establishes an office within Commerce to encourage the formation of export trade associations. In addition, the section requires that a task force be appointed seven years after enactment of this bill to examine the effect of these trade associations.

Title III applies the Domestic International Sales Corporation (DISC) rules to export trading companies and directs the Secretary of Commerce to prepare and distribute information on the application of these rules.

5. Cost estimate:

Authorization amount:	
Fiscal year:	*Millions*
1981	$20
1982	20
1983	20
1984	20
1985	20
Estimated outlays:	
Fiscal year:	
1981	15
1982	20
1983	20
1984	20
1985	20

6. Basis of estimate: This estimate assumes enactment of this legislation before October 1, 1980. It further assumes that the annual authorization amounts will be appropriated in full in the year authorized.

The only direct budget cost estimated for the bill occurs in Title I which authorizes the annual appropriation of $20 million to the Economic Development Association and Small Business Administration. Outlays were derived by applying a composite outlay rate. Loan guarantees of the Export-Import Bank are assumed to be provided within the annual limitation on program activity. In any case, guarantees are estimated not to be drawn and therefore result in no budget authority or outlays.

While Title II creates an office within the Department of Commerce, there is no authorization for appropriation for the office. It is assumed, therefore, that funds for this office will be transferred or reprogrammed to fulfill this section. The task force requirement is beyond the projection period; no costs are included for this provision.

The provisions of Title III, allowing certain export trading companies to be treated as DISCs, will reduce corporate profit tax receipts. In the time available, however, CBO has not been able to estimate the amount of the reductions.

7. Estimate comparison: None.
8. Previous CBO estimate: None.
9. Estimate prepared by: Rita Seymour and Rosemary Marcus.
10. Estimate approved by:

C. G. Nuckols,
(For James L. Blum,
Assistant Director for Budget Analysis).

Evaluation of Regulatory Impact

In the opinion of the Committee, it is necessary to dispense with the Rules of the Senate, the Committee has evaluated the regulatory impact of this bill. The Committee concludes that the bill will have no additional regulatory impact.

27

CHANGES IN EXISTING LAW

In the opinion of the Committee, it is necessary to dispense with the requirements of section 4 of Rule XXIX of the Standing Rules of the Senate in order to expedite the business of the Senate.

COMPTROLLER OF THE CURRENCY,
ADMINISTRATOR OF NATIONAL BANKS,
Washington, D.C., May 12, 1980.

Hon. WILLIAM PROXMIRE,
Chairman, Committee on Banking, Housing and Urban Affairs, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the views of the Office of the Comptroller of the Currency (OCC) on the proposed "Export Trading Company Act of 1980", S. 2379.

The proposed legislation promotes the expansion of U.S. exports by permitting the formation and operation of export trading companies ("ETCs"), which would facilitate the marketing and export of goods and services on behalf of small and medium sized U.S. firms. S. 2379 also proposes a leading role for U.S. banks informing and operating ETCs.

The OCC strongly supports S. 2379 with certain reservations. The OCC believes in the need to expand U.S. exports, as well as in the benefits of employing the national and international marketing and financial networks of U.S. banks for export expansion. Bank ownership of ETCs does raise supervisory concerns; however, the OCC believes the proposed legislation can be amended to address those concerns while still permitting a leading role for banks in ETCs.

Specifically, the OCC's primary concern is the degree of exposure a bank-owned ETC may raise for the bank investor. Exposure can be the amount of loans and investment a bank provides an ETC. However, exposure also can include a bank's moral obligations on behalf of a subsidiary which is closely identified with the bank through equity participation, and borrows in the marketplace on the basis of that equity interest.

Accordingly, the OCC suggests the proposed S. 2379 be amended to recognize these supervisory concerns. This Office especially recommends during this threshold stage of ETC development that the proposed legislation permit a banking organization to invest the lower of $10 million or five percent of its consolidated capital funds in less than twenty-five percent of the equity of an ETC without the prior approval of the appropriate federal banking agency. Aggregate bank investments in ETCs should be limited to 10 percent of a banking organization's consolidated capital funds. At a minimum, any investments by banks in ETCs which require prior approval should be subject to whatever safety and soundness conditions the appropriate banking agency may wish to impose.

Sincerely,

JOHN G. HEIMANN,
Comptroller of the Currency.

28

THE SECRETARY OF COMMERCE,
Washington, D.C., May 12, 1980.

Hon. ADLAI E. STEVENSON,
U.S. Senate,
Washington, D.C.

DEAR ADLAI: This letter supplements my April 3, 1980, testimony on S. 2379 and S. 864 with a more detailed Administration position on an antitrust exemption for export trade activities.

As you know, I reported during my April 3 testimony that the Administration had been unable to agree on the form of participation by the Justice Department in the process of certifying certain export activities to be exempt from application of the antitrust laws. Since that time, extensive consultations among the Commerce Department, USTR, the Justice Department, and other agencies have led to Administration agreement upon the form of that participation. Accordingly, I am pleased to state on behalf of the Administration that, with the few changes I have noted below, we could support an antitrust provision for export trade associations and export trading companies such as that contained in title II of the draft committee print of May 3, 1980. (The Administration has not yet considered whether the antitrust exemption should be applicable, as proposed in the May 3 print, to individual companies, other than export trading companies, which are not part of an export trade association.)

1. The Administration believes that the Attorney General and the Federal Trade Commission should have an opportunity to review any certificate that the Commerce Department proposes to issue before that certificate becomes effective. This review would allow for consultations between the Commerce Department and the antitrust enforcement agencies in an effort to avoid issuing certificates for activities that would have anti-competitive effects in the United States. The Commerce Department would be free to issue a certificate even if an antitrust agency objected. However, when such an objection had formally been lodged, the antitrust exemption provided for in the certificate would not take effect for thirty days. I have enclosed language drafted by the Administration to implement this principle.

2. The Administration believes that the Attorney General or the Federal Trade Commission should be able to seek preliminary relief during this thirty-day period to prevent the antitrust exemption from taking effect. Normal judicial standards for preliminary relief in antitrust cases would apply. Therefore, the following language, which appears in other antitrust laws, should be included in the provision for invalidation of the certificate by the Attorney General or the Commission:

> Pending such action, and before final decree, the court may at any time make such temporary restraining order or prohibition as shall be deemed just in the premises.

In this regard, the provision requiring thirty-day notice before an antitrust agency institutes an action for invalidation is inappropriate and should not apply in the case of an action brought in any thirty-day period before an exemption takes effect.

3. In order for the antitrust enforcement agencies to comment knowledgably upon the competitive consequences of granting a certificate,

these agencies must have the information provided by applicants for certificates. However, the agencies need this information only where they will actually be called upon to comment. Accordingly, the following language should be included in the beginning of the provision on discosure of information to the Attorney General and the Commission:

> Whenever the Secretary believes that an applicant may be eligible for a certificate, or has issued a certificate to an association or export trading company, he shall promptly make available all materials filed by the applicant, association or export trading company, including applications and supplements thereto, reports of material changes, applications for amendments and annual reports, and information derived therefrom.

We are, of course, prepared to assist you or the Committee in any way in drafting suitable language or in rectifying the minor drafting problems in the current draft committee print.

Sincerely,

PHILIP W. KLUTZNICK,
Secretary of Commerce.

FEDERAL RESERVE SYSTEM,
Washington, D.C., May 12, 1980.

Hon. ADLAI E. STEVENSON,
U.S. Senate,
Washington, D.C.

DEAR SENATOR STEVENSON: My letter to you of May 2 expressed certain reservations regarding S. 2379. Those reservations stem not from lack of sympathy with the purpose of this legislation in making export related services available to more firms in the U.S. Rather, we in the Federal Reserve have substantial questions about the degree to which banking organizations should be permitted to participate directly in, or even control, export trading companies. In that connection, we feel strongly that the tradition of separation of banking and commerce has served the country well. To assure that separation is maintained, while permitting a degree of banking participation in support of export trading companies. I would suggest certain amendments to the proposed bill establishing substantive and procedural standards that are necessary with regard to bank involvement in such companies.

Those recommendations, which I endorse, include the following elements: first, no banking organization would be permitted to acquire more than 20 per cent of the voting stock of an export trading company or to control the company in any other manner; second, not more than 50 per cent of an export trading company's voting stock could be owned by any group of banking organizations; third, the aggregate investment by any banking organization would be limited to 5 per cent of its aggregate capital and surplus (25 per cent in the case of Edge and Agreement Corporations) in one or more export trading companies nor could a banking organization lend to an export trading company in an amount which, when combined with its investment, would exceed 10 per cent of the banking organization's capital and surplus; an export trading company would not be permitted to take positions in securities or commodities for speculative purposes; an arms length relationship would be maintained in any lending activity; and the name of the bank could not be used in the name of the export trading company.

Furthermore, we propose that any major commitment to investment in an export trading company—in excess, say, of $10 to $15 million—be specifically approved by the Board of Governors in advance. As this suggests, we believe that because of the risks that may attend export trading company activities and the lack of experience of U.S. banks and their regulators in dealing with such companies, it would not be prudent to permit banking organizations to exercise control over export trading companies at this time. For that reason, the Board of Governors cannot support the current version of S. 2379.

The amendments that I am enclosing for the Committee's consideration have been discussed with your staff. We, of course, would be pleased to provide any further assistance.

Sincerely,

PAUL A. VOLCKER.

ADDITIONAL VIEWS OF SENATOR WILLIAM PROXMIRE

I find it unfortunate that important banking legislation was reported by the Committee on Banking, Housing and Urban Affairs without the Committee having had the benefit of appearance before it of the bank regulatory agencies charged with the safety and soundness of the banking system.

Unquestionably it would have been inconvenient for the movers of this legislation to have heard first hand the doubts of the banks regulatory agencies which bear the ultimate responsibility for underwriting the liquidity and solvency of the banking system.

But the inconvenience of listening to responsible contrary views just might have given the Senate a better understanding of the magnitude of this legislation and its potential effect of the public interest.

Let us make no mistake about it, this is major banking legislation. It breaks the demarcation between banking and commerce because it allows banks to take controlling equity positions in export-import companies, trading goods of production and commodities. Historically, banking and commerce have been separated by law in this country. This has been so for over 100 years for good reason. Banks play a significant role in the life of our economy by safeguarding the Nation's savings and providing the lifeblood of our economic system: credit. Credit judgments should be made on the merits. Arms length dealing in the credit mechanism has been ensured by the traditional separation of banking and commerce.

When a bank has a stake in economic enterprise its credit judgments tend to be skewed. The most recent example is the involvement of banks in the real estate inevstment trust business where bank losses ran to the hundreds of millions of dollars. Congress, in fact, had to adopt special legislation just this year to bail out large banks holding real estate in connection with REIT defaulted loans, so that those banks would not have to charge off large losses to their already depleted capital base. Now, the same big banks are to be given the power to engage in lines of commerce in which they have no expertise.

This legislation gives rise to identical risks to the banking industry which came out of the REIT experience, only the risks are far greater this time. The ramifications of this legislation are enormous. Banks would be permitted to take controlling equity positions in Export Trading Companies. A bank owned Export Trading Company would be permitted to engage in a wide range of export-import transactions. Such a bank owned Export Trading Company would be permitted to contract to build a textile mill in China, purchasing the equipment both in the U.S. and overseas. In payment for the mill, the Export Trading Company could take oil in a barter transaction, ship the oil to the U.S. market on tankers which it would be permitted to own, and market the oil in the U.S. The bank owned Export Trading Company could purchase wheat or grain in the forward market for sale in international markets pursuant to their marketing efforts. Such an Export Trading Company would be permitted to engage in the travel agency business overseas and for travel to and from the United States; amusements for export would be permitted, no doubt including motion pictures.

While banks may provide a useful service to Export Trading Companies in providing financing and financial services to exporters, it is clear to me that banks have no expertise to offer in actual construction projects, purchase and sale of commodities and barter transactions which may include exporting a truck factory and importing vodka in payment.

Thus, while I remain skeptical of the entire Export Trading Company concept for banks at all, I can understand that perhaps to facilitate the financial aspects of export-import transactions banks may need to have a non-controlling position in an Export Trading Company.

That is why I supported the Federal Reserve Board amendment prohibiting bank control of Export Trading Companies and which would have restricted any bank's investment in an Export Trading Company to a non-controlling interest, not to exceed 20 percent of the Export Trading Companies stock and to restrict the interest of several banks in a single Export Trading Company to under 50 percent. The Federal Reserve amendment—which was supported by the Federal Deposit Insurance Corporation—would have retained the benefits of bank participation in Export Trading Companies while avoiding the pitfalls associated with bank control of commercial enterprises.

The pitfalls are substantial. At a time when the banking system is undercapitalized and with the shortage of capital being particularly acute at large banks, the needs of a soundly capitalized banking system require at the largest banks that banks not be encouraged to drain capital away from their credit function. We should remember all to well the unfortunate consequences of the recent era of "go-go" banking and REITs and not encourage banks to stray from their essential economic purpose which is to provide financing for productive purposes.

Controlling equity investments in lines of commerce holds the probability that the public will suffer the consequences as it did in the REIT experience and "go-go" banking of recent years. Those consequences include the need for Congress to pass special legislation to allow banks extended time to hold real estate held in connection with defaulted loans made for speculative lending purposes; Federal Reserve lending to prevent bank failures; and ultimate FDIC funding to prevent deposit payouts by banks in receivership.

It is clear to me that in breaching the 100 year old separation between banking and commerce that prudence dictates caution. The Federal Reserve amendment would have allowed bank participation in Export Trading Companies while ensuring the prevention of the type of abuses associated with bank expansion into nonbanking activities. The virtue of the Federal Reserve amendment is that it would have given the Congress the option down the road in a year or two based upon the record of limited bank participation in Export Trading Companies to determine whether the public interest would be at all served by bank control of Export Trading Companies. The Committee has made this judgment now, prematurely in my view, without even the benefit of bank regulatory agency participation in open hearings.

This legislation also contains amendments to the Internal Revenue Code which lie completely outside this Committee's jurisdiction. The tax provisions to which I refer would make Export Trading Companies with bank ownership eligible for DISC tax treatment; make receipts from export trade services eligible for DISC tax benefits; and would exclude Export Trading Companies from the requirements of Subchapter S relating to closely-held corporations requiring that 20 percent of such a corporation's annual income be domestic income. I am afraid that the Committee's action on the tax code is another example of the questionable procedures that have been followed in considering this bill. That bill should not be considered at all by the Senate until the tax writing committees have given detailed consideration to these tax provisions.

On substantive grounds, I join with the Administration in opposing this major expansion of the tax benefits afforded to export activities.

In the most recent Committee hearings on this legislation, Commerce Secretary Klutznick, giving the Administration's position, stated the following:

> Many, if not all, ETCs should be able to meet the requirements of present DISC legislation and benefit from DISC tax deferral status. Modification of U.S. banking laws to permit bank ownership of export trading companies will effectively expand DISC coverage without requiring any change in the DISC statute itself. However, to amend DISC legislation to cover exports of all services, as well as services provided by other U.S. firms to export trading companies, as S. 2379 would do, would definitely alter the nature and scope of the DISC program and substantially increase its revenue costs. The present realities of the budget situation do not permit such an extension at this time. I could also raise questions about our international obligations in this area and our concerns for tax equity.

Assistant Treasury Secretary Bergsten subsequently provided the Committee with a more detailed statement of the Administration's position and with estimates of the potential impact of Title III on tax revenues. Giving what were styled as "conservative estimates," the Bergsten letter stated that the extension of DISC benefits to "services produced in the United States" could result in revenue losses of $200 to $500 million and similar coverage of "export trade services" could cost the Treasury $100–$200 million. I also agree with the Administration's opposition to the amendments to Subchapter S contained in Title II on the ground that any legislation of this sort should be considered within the context of the proposal by the Joint Committee on Internal Revenue Taxation to overhaul Subchapter S. This seems to me to be perfectly reasonable and in fact far preferable to precipitous actions by this Committee.

34

Lastly, this legislation contains a major revision to the Webb-Pomerene Act which now contains a limited exception to the proscriptions of the Sherman Act for joint ventures which are limited to exports. I know that the authors did not intend to make substantive changes in the Webb-Pomerene exceptions. Nevertheless, I believe the Senate would have been better served if the Judiciary Committee—with its antitrust expertise—had reviewed these provisions in hearings. Once again, the procedure followed here to rush a bill to the Senate floor may not serve the public interest well. Antitrust laws are complicated and they deserve careful consideration. Especially is this so with respect to this bill which ousts the Justice Department Antitrust Division out of the Administration of the Webb-Pomerene Act in favor of the Commerce Department. With all due respect to the Commerce Department, I think it fair to say that it has no expertise at all in enforcing the antitrust laws. In my judgment, it is no answer to say that if Commerce makes a mistake Justice can sue them in the courts. Courts are not administrators. Enforcement action will be at the desk in Commerce which reviews the application for exceptions to the antitrust laws. The Senate needs to ask itself if the public deserves the defanging of the Antitrust Division of the Justice Department, especially in the light of the fact that upon Commerce Department approval carries with it immunity from suit by private parties and state attorneys general on behalf of persons who might have been injured by reason of agreements in restraint of trade.

WILLIAM J. PROXMIRE.

FEDERAL RESERVE SYSTEM,
Washington, D.C., May 12, 1980.

Hon. WILLIAM PROXMIRE,
Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR CHAIRMAN PROXMIRE: My letter to you of May 2 expressed certain reservations regarding S. 2379. Those reservations stem not from lack of sympathy with the purpose of this legislation in making export related services available to more firms in the U.S. Rather, we in the Federal Reserve have substantial questions about the degree to which banking organizations should be permitted to participate directly in, or even control, export trading companies. In that connection, we feel strongly that the tradition of separation of banking and commerce has served the country well. To assure that separation is maintained, while permitting a degree of banking participation in support of export trading companies, I would suggest certain amendments to the proposed bill estabilshing substantive and procedural standards that are necessary with regard to bank involvement in such companies.

Those recommendations, which I endorse, include the following elements: first, no banking organization would be permitted to acquire more than 20 percent of the voting stock of an export trading company or to control the company in any other manner; second, not more than 50 percent of an export trading company's voting stock could be owned by any group of banking organizations; third, the aggregate investment by any banking organization would be limited to 5 percent of its aggregate capital and surplus (25 percent in the case of Edge and Agreement Corporations) in one or more export trading companies nor could a banking organization lend to an export trading company in an amount which, when combined with its investment, would exceed 10 percent of the banking organization's capital and surplus; an export trading company would not be permitted to take positions in securities or commodities for speculative purposes; an arms length relationship would be maintained in any lending activity; and the name of the Bank could not be used in the name of the export trading company.

Furthermore, we propose that any major commitment to investment in an export trading company—in excess, say, of $10 to $15 million—be specifically approved by the Board of Governors in advance. As this suggests, we believe that because of the risks that may attend export trading company activities and the lack of experience of U.S. banks and their regulators in dealing with such companies, it would not be prudent to permit banking organizations to exercise control over export trading companies at this time.

The amendments that I am enclosing for the Committee's consideration have been discussed with your staff. We, of course, would be pleased to provide any further assistance.

Sincerely,

PAUL A. VOLCKER.

ADDITIONAL VIEWS OF SENATORS TOWER, CRANSTON, AND GARN

The purpose of the Export Trading Company Act of 1980, as stated in Sec. 102(b) thereof, is to increase United States exports of products and services by encouraging more efficient provision of export trade services to American producers and suppliers. We fully support this objective. The sooner our merchandise trade balance becomes a surplus rather than a deficit, the healthier our economy will be.

We are concerned, however, that this bill provides a significant departure in the manner in which our financial institutions have traditionally operated. Throughout our history, commercial banks have financed commercial activities. They have not maintained ownership interests in commercial ventures. There are many questions that have been raised by the provision in the bill allowing banking organizations to obtain ownership interests in commercial ventures. These questions relate to areas such as the safety of accounts of bank depositors, the safety of stockholder interests in banking organizations, and the ability of banking organization personnel to manage commercial ventures, to name a few.

Proponents of a strong banking organization role in an export trading company argue that active participation or control is necessary because many banking organizations have foreign branches, and therefore, have commercial contacts both domestically and abroad. A banking organization, it is argued, can serve as the catalyst that will bring together U.S. businesses and foreign markets. "Banking organizations" is defined by the bill to include state and national banks, as well as bank holding companies, bankers' banks, Edge Act Corporations and Agreement Corporations.

Our primary concern is for the protection of the depositors and shareholders in our commercial banks. Additionally, we are very concerned about the manner in which some of these financial institutions might operate in the future. The hearing record is virtually silent on these questions. In almost 1,000 pages of printed testimony there are but a few paragraphs which touch upon this area. Most of these comments questioned this new role of commercial banks. Treasury Assistant Secretary C. Fred Bergsten testified that:

> It is a long established principle in this country that banks should not be owners of commercial organizations. Giving banks an equity interest in the success of a commercial venture could bias their lending, trust, and other activities, and could require substantial policing to insure that such financial relationships are based solely on sound and equitable business considerations. The basic tenet of American law, that banking and banking related activities should be separate from other business practices, demonstrates the difficulty of transferring

to the United States the Japanese model, where bank-firm relationships are an integral part of the entire business and commercial structure.

Additionally, Paul Volcker, Chairman of the Federal Reserve Board, has expressed reservations about an expansion of the scope for banks to invest in commercial activities. The American Bankers Association has not appeared to testify on the bill and has no current position on the proposed legislation. Several officers of commercial banks whom we have contacted regarding this proposal have expressed a very cautious and "go-slow" approach to changing the powers of banking organizations.

In summary, we are concerned about the mounting merchandise trade deficit of the last few years. Much of this deficit results from declining domestic business productivity coupled with increases in the price and volume of energy imports. While we believe that export trading companies have an important role to play in increasing export opportunities, we do not believe they are a panacea for resolving our balance of trade problems. The model of the export trading company as it is known in Japan or Western Europe is not well understood by American businesses. It remains to be seen how it might adapt to U.S. business practices or how U.S. business practices might change to accommodate the model of foreign export trading companies. Until a better record is built as to how banking organizations might adjust to the new climate of not only financing, but directly participating in the management of commercial organizations, we believe it is wise to proceed very cautiously in promoting this new area of commercial activity.

JOHN TOWER.
ALAN CRANSTON.
JAKE GARN.

THE FINANCIAL COLLAPSE OF THE REIT INDUSTRY: AN ANALYSIS AND PROPOSED REGULATORY FRAMEWORK

*Jasper G. Taylor III**

* Associate, Fulbright & Jaworski, Houston, Texas; B.S. 1973, University of Florida; J.D. 1978, Duke University; CPA, State of Florida.

The author wishes to express his appreciation to Professor Martin E. Lybecker for his invaluable comments on an earlier draft of this article.

I. Introduction

The Real Estate Investment Trust (REIT), which was proclaimed in the 1960's to be the investment vehicle that would provide the small-time investor with the benefits of big-time real estate finance,[1] has instead been the source in the 1970's of large scale litigation and heavy monetary loss for REIT shareholders and debenture holders.[2] While the concept of the "business trust" was not

1. Greer, *Realty Investment Trusts Again Falling by Wayside*, Wash. Post, June 24, 1974, at D 11.
2. See text accompanying notes 62-157 *infra*.

a new one,[3] the changes made in the Internal Revenue Code by Congress in 1960 provided the tax benefits to certain of these trusts that would enable them to compete effectively for the public's investment capital.[4] As the tax-free pooling of investors' capital in mutual funds allows the small investor to achieve the benefits of diversification normally available only to the very wealthy,[5] the tax-free pooling in REITs was intended by Congress to enable the small investor to participate in large-scale real estate development hitherto reserved to large syndications of wealthy investors.[6]

While most REITs initially met with success, earning large profits and paying out high dividends,[7] the early 1970's found many REITs struggling with extreme financial difficulties.[8] These financial problems spread among the REIT industry, eventually worsening and causing the demise of most REITs. While the factors which

---

3. The "Massachusetts business trust" came into widespread use during the late 1800's. While the structure and legal attributes were that of a trust, with trustees and beneficiaries, the entity was basically an incorporated association, pooling the capital of the beneficiaries in the pursuit of a single business venture. 4A R. POWELL, REAL PROPERTY (1972).

4. Congress in 1960 amended the Internal Revenue Code through the Real Estate Investment Trust Act. I.R.C. §§ 856-858. A business trust, see note 3 *supra*, which derives most of its income from investments in real estate, *Id.* § 856(c)(2)-(4), and which meets certain other requirements relating to the nature of its assets, *Id.* § 856(c)(5), and distribution of income to shareholders, *Id.* § 857(a)(1), will not be taxed on the trust's income which is distributed to shareholders. *Id.* § 857(b).

The concern of Congress may have been that, because the income distributed by mutual funds was taxed only to the fund's shareholders, investment in traditional industrial stock was being unduly encouraged over investment in real estate through business trusts, which were taxed as corporations. *See* Thomas, *Real Estate Fall-Out-REIT Collapse Puts Lots of Property Up For Grabs*, BARRON'S DAILY NEWS ITEMS, July 22, 1974, at 1. Therefore, the grant of special tax benefits to REITs could have been the result of a desire to spur investment in real estate by granting parity with mutual funds. *See REIT's Face Shake-Out As Investments Sour, Cash Sources Dry Up*, Wall St. J., Jan. 21, 1974, at 1, col. 1. *See also* Lynn, *Real Estate Investment Trusts: Problems and Prospects*, 31 FORDHAM L. REV. 73 (1962), where the author notes the irony of granting special tax treatment to REITs based on a comparison to mutual funds, but without the corresponding regulation.

It could be argued, however, that the 1960 Act actually gave REITs a distinct tax advantage over mutual funds. The income that is finally distributed to a mutual fund shareholder has been taxed once already prior to reaching the mutual fund itself—the corporation in whom the fund has invested has paid corporate income tax on its annual earnings. The income distributed by an REIT, however, has not been taxed prior to receipt by the trust, because the income is generated from earnings of a real estate entity owned by the trust itself, or as interest on a loan made by the trust for real estate construction or development.

5. FINANCIAL INSTITUTIONS 448 (L. Farwell ed. 1966).

6. *See* Biderman, *After the Fall—Many Real Estate Investment Trusts Continue to Prosper*, BARRONS, Oct. 30, 1972, at 5; *Kenseth, Lien Years and Fat—Real Estate Investment Trusts are Making an Impressive Record*, BARRONS, Nov. 1, 1971, at 5.

7. See text accompanying notes 38-91 *infra*.

8. See text accompanying notes 62-97 *infra*.

caused the decline of the REIT may be many and varied,[9] the lack of a regulatory or disclosure framework as the *quid pro quo* for the grant of special tax benefits to REITs, as was done in the case of mutual funds,[10] was probably the most important factor.

This article will examine the structure[11] and recent history[12] of the REIT industry in an attempt to isolate the factors which led to that industry's decline. After an analysis of the legal protections now available to REIT investors and the effectiveness of such protections,[13] a federal statutory framework will be proposed that will be intended to serve as a response not only to the problems which caused financial disaster for the REITs,[14] but also to the deficiencies in regulation that allowed for real or potential abuse of REIT shareholders and creditors.[15]

II. The Structure and Nature of the Reit

Crucial to an understanding of many of the problems that have befallen the REIT industry is a familiarity with the structure of an REIT, the relationships between an REIT and the third parties with which it deals, and the nature of an REIT's portfolio.

A. *The Basic Structure of an REIT*

The REIT is basically an unincorporated association organized for the purpose of investing the capital of many in various real estate ventures.[16] While an REIT is of course cast in the form of a trust, many of its attributes bear more resemblance to that of a corporation. First of all, unlike the usual trust, which holds legal title for only a few beneficiaries, the REIT is required by the Internal Reve-

9. See text accompanying notes 38-97 *infra*.

10. The mutual fund, or investment company, industry was the subject of extensive regulatory legislation in 1940. This legislation, the Investment Company Act, 15 U.S.C. §§ 80a-1-80a-52 (1970), contains very specific provisions, including those relating to the capital structure of investment companies, the duties of their trustees and advisers, and the regulation of transactions fraught with conflicts of interest. For a discussion of the Investment Company Act's provisions, the existing deficiencies, and proposed changes to correct these deficiencies, see Rosenblatt & Lybecker, *Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project*, 124 U. Pa. L. Rev. 589, 590-654 (1976).

11. See text accompanying notes 16-31 *infra*.

12. See text accompanying notes 32-99 *infra*.

13. See text accompanying notes 100-156 *infra*.

14. See text accompanying notes 196-208 *infra*.

15. See text accompanying notes 158-194, 209-214 *infra*.

16. See text accompanying note 6 *supra*.

nue Code to hold title for at least 100 beneficial owners.[17] In addition, investment by the public in REITs has taken the form of debentures in addition to that of stock,[18] which is a form of financing uncommon to trusts. Finally, the trustees of an REIT perform their duties much like the directors of a corporation—exercising only general control over the REIT and delegating the day-to-day operation of the trust to third parties.[19]

The delegation by the trustees of the day-to-day operation of the REIT is done by contract to an "investment adviser," who most often is the promoter or sponsor of the REIT.[20] In return for the "adviser's fee," this adviser is also responsible for locating suitable investment opportunities.[21] The role of "investment adviser" has been filled most often by commercial banks, but insurance companies and mortgage bankers have also performed this function.[22]

B. The Nature of an REIT's Portfolio

There are two basic types of REITs, the classification of which is based upon the nature of the REIT's holdings. One type of REIT

17. I.R.C. § 856(a)(6).

18. *When Is a Lemon A Lemon?*, FORBES, Mar. 15, 1974, at 63. *See also A REIT Files for Protection Under Chapter 11*, Wall St. J., Mar. 18, 1974, at 5, col.1, where it is reported that out of a total debt of $57 million, Associated Mortgage Investors owed $10 million to some 885 holders of junior debentures.

19. Kelley, *Real Estate Investment Trusts After Seven Years*, 23 BUS. LAW. 1001, 1006-07 (1968). *See generally* Parker, *REIT Trustees and the "Independent Contractor"*, 48 VA. L. REV. 1048 (1962).

20. Korobow & Gelson, *REIT's: Impact on Mortgage Credit*, 40 APPRAISAL J. 43 (1972).

21. *Real Estate Trusts Consider Lowering Fees Paid to Advisers*, Wall St. J., Apr. 26, 1973, at 32, col. 1.

22. For example, the nation's largest REIT for a time was Chase Manhatten Mortgage & Realty Trust, whose adviser and sponsor was Chase Manhattan Bank. *REIT's Display Serious Market Malady*, Wash. Post, July 21, 1974, at F 1, col. 1. Another of the largest REITs was Connecticut General Mortgage & Realty Investments, whose sponsor and adviser was a subsidiary of Connecticut General Life Insurance Corporation, Hartford. *Connecticut General Mortgage Is Changing Basis of Advisers Fee*, Wall St. J., Mar. 21, 1974, at 5, col. 1. The investment adviser to North American Mortgage Investors and Mortgage Growth Investors was Sonnenblick-Goldman Corporation, a major mortgage banking concern. Abele, *Real Estate Trusts*, N.Y. Times, Nov. 28, 1971, at 6, col. 1. Much of the impetus for the creation of REITs by banks and insurance companies was provided by underwriters who were anxious to collect big underwriting fees and commissions from peddling shares in the open market. Robertson, *How the Bankers Got Trapped in the REIT Disaster*, FORTUNE, Mar., 1975, at 113; *REIT's Face Shake-Out as Investments Sour, Cash Sources Dry Up*, *supra* note 4.

While there existed very few REITs not sponsored by a commercial bank, insurance company, or mortgage banker, some of these independent REITs were among the largest and most successful in the industry. For example, Continental Mortgage Investors and First Mortgage Investors, who were among the ten largest REITs in the early 1970's, used publicly-held investment firms as their advisers. Biderman, *supra* note 6.

is the "equity" trust,[23] which uses its funds to actually purchase income-producing properties such as apartment buildings, shopping centers, and other rental properties.[24] These properties are not actually operated by the REIT itself, but by management companies hired by the trustees of the REIT.[25] "Equity" trusts were the initial form of REITs and have performed well and dependably over the long run.[26]

The second type of REIT is the "mortgage trust," which specializes in the financing of real estate properties.[27] These trusts function much as commercial banks would, lending funds for construction as well as for long-term development.[28] The profits of these trusts are generated by the "spread" between the interest earned on outstanding mortgages and the cost of capital used by the REIT to make the loans.[29] While some mortgage trusts invest their funds in long-term instruments, most of the REITs existing in the early

---

23. "Equity" trusts may be further subdivided into five categories, once again based upon the nature of their holdings:

> (1) *exchange-trust*—the beneficiaries of such a trust exchange property they own for a beneficial interest in the trust;
>
> (2) *blank check trust*—the trustees are authorized to purchase property of any kind, so long as it in their best judgment possesses good "investment potential";
>
> (3) *purchasing trust*—the trustees have authority to purchase only specific properties described in the prospectus by which an offering is made;
>
> (4) *mixed trust*—some of the trusts' funds may be used to purchase as a "blank check trust" would, while the remainder is used to purchase specific properties as described in the prospectus; and
>
> (5) *existing trust*—this type of trust has already purchased the properties it wishes to operate; the advantages it offers are that the original costs have already been paid, and the trust's management is seasoned and proven.

See Godfrey and Bernstein, *The Real Estate Investment Trust—Past, Present and Future*, 1962 WIS. L. REV. 637, 665-66 for a discussion of these basic types of "equity" trusts.

24. *REIT's Display Serious Market Malady*, *supra* note 22.

25. This is true not because REITs find it more efficient or convenient to contract with others to perform this function, but because the Internal Revenue Code forbids any REIT trustee to be an officer or employer of, or have a proprietary interest in, any independent contractor which furnishes or renders services pertaining to trust property or manages or operates such property. I.R.C. § 856 (1970). This provision was motivated by the desire of Congress to give "conduit" tax treatment only to those trusts principally involved in the mere ownership of real property interests, rather than the realization of income from the active management of real property or the provision of associated service functions, as would be the case for operators of hotels, apartment complexes, etc. *See* Parker, *REIT Trustees and the "Independent Contractor,"* 48 VA. L. REV. 1048 (1962).

26. *REIT's Display Serious Market Malady*, *supra* note 22.

27. *Id.*

28. *New Lows for the Once Mighty REIT's*, BUS. WEEK, Apr. 20, 1974, at 82, col. 1.

29. *REIT's Face Shake-Out As Investments Sour, Cash Sources Dry Up*, note 22 *supra*. The "spread" for an REIT is the difference between the REIT's cost of capital (whether paid in interest or dividends) and the rate of interest the REIT charges on its loans.

1970's invested in high-yielding, short-term mortgages, such as construction and development loans and interim financing.[30] The mortgage trusts are quite susceptible to downturns in the economy, however, and have suffered from financial difficulties much more than "equity" trusts.[31]

III. The Rise and Fall of the Reit—A Brief History

While the REIT industry officially began with the 1960 amendments to the Internal Revenue Code,[32] there was no appreciable growth or economic activity until the late 1960's. Until that time, there existed only a handful of "equity" trusts[33] that derived their income from rentals produced by the real estate properties they owned.[34] The revenues generated by these properties came chiefly from long-term leases, so that the rapidly increasing cost of inflation resulted in a fairly low rate of return.[35] While the performance of these early REITs was quite dependable, and there was an absence of any notable failures,[36] the low rate of return restrained any excitement that might have existed in the investment community, and total REIT assets stood at only $1 billion in early 1968.[37]

The turning point came shortly thereafter, however, when some of the largest REITs experimented with investing their funds in short-term mortgages, such as construction and development loans, which were made at much higher interest rates than those of long-term mortgages.[38] Combining this loan strategy with a high degree of leverage, by borrowing heavily from commercial banks and the

---

30. *See, e.g.*, Abele, *supra* note 22. There also existed, of course, REITs that invested their funds in both equites and mortgages. B.T. Saul Real Estate Investment Trust, for example, was such a "hybrid" trust. Biderman, *supra* note 6.

31. *REIT's Display Serious Market Malady*, *supra* note 22.

32. I.R.C. §§ 856-868.

33. See notes 23-26 *supra* and accompanying text for a discussion of the characteristics of an equity trust.

34. For example, two of the oldest REITs in existence today are American Realty Trust and Real Estate Investment Trust of America, both of which are equity trusts which have maintained steady but fairly modest dividend rates. Lurov, *Out of the Cellar? The Market is Down on Real Estate Investment Trust Warrants*, BARRON'S, Mar. 27, 1972, at 5, col. 1.

35. The earnings of equity trusts during this period tended to average approximately three to four percent above the trusts' cost of capital. Kenseth, note 6 *supra*.

36. *REIT's Face Shake-Out As Investments Sour, Cash Sources Dry Up*, *supra* note 4.

37. Abele, *supra* note 22.

38. Two of these REITs were Continental Mortgage Investors and First Mortgage Investors, who also were the largest of the REITs unaffiliated with a major bank, insurance company, or mortgage banker. Kenseth, *supra* note 6.

public,[39] led to impressive growth both in terms of earnings and in total portfolio assets.[40]

This extraordinary development of course did not go unnoticed, and many real estate promoters and medium-size financial institutions began to set up their own REITs.[41] Most of these REITs, however, invested their funds in long-term mortgages and not in the shorter term construction loans.[42] It was at this time, though, that spectacular growth occurred due to the "credit crunch" of the late 1960's.[43] Because this "money squeeze" caused commercial banks, the traditional supplier of loans for real estate development, to restrict large lending to their most favored corporate customers, there existed a wealth of development opportunities in which REITs could invest.[44] The REIT industry took advantage of these opportunities, further improving their already impressive record and luring major financial institutions into the establishment of affiliated REITs.[45]

During this period of approximately two years, it was quite easy for the average REIT to obtain an infusion of public capital. The stock of some of the larger REITs was selling at thirty-six times earnings, and shares in new offerings were selling for a twenty to thirty percent premium on the day of issue.[46] In addition to tapping the equity capital market, REITs also sold junior debentures to the public and issued their own commercial paper.[47] This easy access to the investment capital market came briefly to an end in late 1969

39. Note, *Real Estate Investment Trusts: A Current Assessment*, 39 BROOKLYN L. REV. 590, 602 (1973). Leveraging, which is the incurring of debt in amounts greater than shareholders' equity, can greatly increase earnings, especially for an REIT. If an REIT can continue to borrow funds at an interest rate lower than that at which it loans out the funds, maintaining its "spread," the total amount of earnings will of course increase. *See* Robertson, *supra* note 22, at 169.

40. Lurov, *supra* note 34.

41. Thomas, *supra* note 4.

42. *REIT's Face Shake-Out As Investments Sour, Cash Sources Dry Up*, *supra* note 4.

43. The term "credit crunch" refers to the situation that exists when the Federal Reserve Board raises the interest rate at which member banks of the Reserve borrow money, or reduces the amount of money it is willing to lend. One mortgage banker has argued that because REITs flourish in this type of situation, lending funds to spur real estate development and construction, they act to defeat the policies of the Board because it often raises interest rates to depress the housing industry. Ostema, *Back to Basics in Real Estate—Trusts Tried Innovations That Served No One Well*, N.Y. Times, July 14, 1974, at F 12, col. 1.

44. Thomas, *supra* note 4.

45. Kenseth, *supra* note 6.

46. *Id.*

47. Robertson, *supra* note 22, at 113.

and early 1970, however, when the price of REIT stock took a drastic plunge.[48]

While there had occurred no erosion in the earnings of REITs that could have precipitated such a downturn, the investing public appeared to be concerned about the future of the REIT industry for several reasons. First of all, the number of REITs had increased to 130 from merely several a few years earlier, causing fears of a glut on the market.[49] Analysts were also concerned that declining interest rates would cause a decrease in earnings[50] and that a sluggish economy could lead to defaults on many of the loans in mortgage REIT portfolios.[51] In addition, there existed a real possibility that, under the law of several states, the shareholder of an REIT could be held liable for its unsatisfied debts.[52]

As a result of a combination of factors, however, the REIT industry recovered in late 1970 and early 1971 to the status of "glamour industry" that it possessed before. One reason for the recovery was the fact that REITs seemed able to maintain a high level of earnings during a period of declining interest rates by using the time lag between a change in the borrowing rate and "pegging" of a mortgage rate to adjust to the situation.[53] Indeed, if a loan commitment had already been made at a specific interest rate, the REIT could increase its "spread" on the loan by obtaining the needed funds at the present lower interest rates.[54]

Yet another reason for the resurgence of the REIT industry was

48. For example, the price-earnings ratio for stock of Continental Mortgage Investors decreased from thirty-six times earnings to twelve times earnings, and shares of American Century Mortgage Investors, which specialized in short-term loans, dropped 25% below their offering price in two months. In addition, new issues were invariably sold at a discount, rather than at the premium that existed before. Kenseth, *supra* note 6.

49. Abele, *supra* note 22.

50. Declining interest rates would mean that more money would be available to financial institutions that compete with REITs for loan opportunities. This might drive down the interest rate charged by REITs, thereby reducing the spread that generates income. Lurov, *supra* note 34.

51. Obviously, if the developer of an industrial park or the owner of a condominium project cannot find tenants or buyers, they will be unable to repay the loans made by the REIT.

52. Under the common law of several states, shareholders of a trust will be held personally liable for the unsatisfied debts of the trust, as they would be if they were partners and the trust a partnership, if the powers of the shareholders grant "control" over the trustees as to the operation of the trust. 4A R. POWELL, REAL PROPERTY § 573 A-1, at 463 (1972). For a more detailed discussion of this problem see the text accompanying notes 164-166 *infra*.

53. Kenseth, *supra* note 6, at 6. "Pegging" of an interest rate by an REIT occurs when the loan agreement specifying an interest rate is executed.

54. *Id.*

the imposition of a freeze on corporate dividends by Phase 2 of the Nixon White House's wage and price controls.[55] While ordinary corporations were forbidden from increasing their dividends, the REITs were required by law to pay out almost their entire annual earnings,[56] so that as REIT earnings increased, so did their dividends.[57] By the late fall of 1971, the total assets controlled by REITs had reached a high of $6 billion and their earnings record had made them "the darlings of Wall Street."[58] While this rapid growth was checked briefly by the extremely pessimistic announcement of a trustee for the nation's largest REIT,[59] the REIT industry continued to attract large amounts of capital from both individual investors and financial institutions, pushing the REIT asset total to nearly $20 billion by late 1973[60] and the number of trusts to nearly 200.[61]

Ironically this period of phenomenal growth and prosperity, however, also was the origin of many of the problems later to face REITs. As the number of REITs increased, along with the amount of money available to be loaned from that industry, competition among REITs for existing investment opportunities became quite fierce.[62] In addition, interest rates began to decline for commercial banks, allowing them to re-enter the real estate development industry and provide still more competition for the REIT industry.[63] The effect of this increased competition was to force REITs to lower the traditional lending standards they had previously followed, because there were only a limited number of prime investment opportunities

55. Biderman, *supra* note 6.

56. Lurov, *supra* note 34.

57. *Id.*

58. Ostema, *supra* note 43.

59. On November 18, 1971, Durand A. Holladay, the secretary and trustee of Continental Mortgage Investors (CMI), announced that CMI would suffer a decline in its earnings for the first time in its history. Mr. Holladay also predicted a decline for the REIT industry in general. The decline, he said, would occur because REITs, pressured by competition from their increasing numbers, were relaxing, if not totally eliminating, traditional lending standards. BARRON'S, Nov. 1971, at 19; *Retreat of the REIT*, NEWSWEEK, Dec. 6, 1971, at 87. While this announcement caused a fifteen to twenty percent drop in REIT stock prices, most REITs had recovered by early 1972. Biderman, *supra* note 6.

Ironically, Mr. Holladay and several other former officers of CMI were later named as defendants in an SEC action which charged them with covering up CMI's shaky financial condition and conspiring to "maintain and increase" the "exhorbitant" management fees paid to CMI's investment adviser. *Former Officers of Continental Mortgage Cited With Price Waterhouse in SEC Suit*, Wall St. J., Jan. 17, 1978, at 8, col. 2.

60. *REIT's Face Shake-Out As Investments Sour, Cash Sources Dry Up*, *supra* note 4.

61. Benger, *Banks' Dismay on REITs*, N.Y. Times, Sept. 29, 1974, at F 2, col. 1.

62. Note, *supra* note 39, at 611-12.

63. Thomas, *supra* note 4, at 1-2.

available.[64] As a consequence, many risky mortgage loans were made that would not have been made before, loans that would come back later to haunt the REITs that made them.[65] It was in mid-1973, with the building and real estate development market saturated,[66] that inflation,[67] a sluggish economy,[68] and the energy crisis[69] began to take their toll on the REIT industry. Builders were having great difficulty completing their projects, because materials and energy became scarce,[70] and developers of condominiums and apartments found it almost impossible to bring down high vacancy rates.[71] Interest rates had also begun to rise at this time, making it extremely difficult for builders to refinance their REIT construction loans by obtaining a long-term mortgage from another source.[72] As a result of these difficulties, many builders and developers began to default on their loans,[73] and because the REIT industry had come to be dominated by trusts specializing in such short-term financing,[74] they were hit especially hard.

The problems that borrowers from REITs were having, however, did not immediately affect the fortunes of most REITs. The

64. Ostema, *supra* note 43. Another reason for the REIT's lack of caution and investigation in making these loans may have been impatience to put "easy money" to work as soon as possible. *See Lessons from Two Building Binges*, FORTUNE, Mar. 1975, at 94, col. 2.

65. See text accompanying notes 73-74 *infra*.

66. Thomas, *supra* note 4, at 2.

67. Carberry, *Heard on the Street*, Wall St. J., Sept. 9, 1974, at 27, col. 1.

68. Benger, *supra* note 61.

69. As we can all well remember, the OPEC oil boycott began after the 1973 Arab-Israeli War and energy sources were quite strained for several months.

70. *New Lows for the Once Mighty REITs*, BUS. WEEK, Apr. 20, 1974, at 82, 84.

71. Another reason for some of the problems faced by condominium developers was the "discovery" in 1973 that the sale of a condominium might involve the offering or sale of a security, which meant that condominium developers and promoters might be brokers or dealers under the Exchange Act and subject to the registration requirements of section 15 of the Act. SEC Securities Act Release No. 5347, Jan. 4, 1973, FED. SEC. L. REP. (CCH) ¶ 79,163. Whatever its causes, the downturn in the condominium market was devastating for most REITs, because so many of the investments made by REITs were in recreation and second-home areas. One financial service estimated that approximately 50% of REIT losses came from the financing of such areas. *Bad Investments*, THE NEW REPUBLIC, Apr. 19, 1975, at 8. Many other investments were in office buildings, which suffered from a lack of business expansion in a depressed economy. *Id.*

72. One commentator has argued that one of the primary causes of the problems faced by REITs was their grant of construction loans without obtaining a mortgage commitment for long-term financing. Ostema, *supra* note 43. In a period of rising interest rates, the builder upon completion finds his equity wiped out when he seeks to arrange for long-term financing. As a consequence, the REIT will have trouble collecting on its construction loan.

73. Robertson, *supra* note 22, at 115, 168.

74. Lamson, *The Uneasy Partnership of Banks and REITs*, N.Y. Times, Mar. 2, 1975, at F 1, col. 1.

method of accounting used by the REITs allowed them to accrue interest income even though cash payments were not being received.[75] Moreover, second loans were made to many troubled borrowers that covered up the problems with the initial loan.[76] Accordingly, because the earnings and growth reported by REITs were not affected, their access to the capital markets, both debt and equity, was not impaired.[77]

With a series of notable defaults, however,[78] the accounting firms that audited REITs, fearful of later lawsuits by bilked shareholders, began to require their clients to obtain appraisals on properties held and analyses of problem loans.[79] Once this process was begun, the auditors found great numbers of loans whose ultimate collectibility was in doubt. As a result of these findings the auditors required additions to a loan-loss reserve, or the halting of interest accrual. Accordingly, those requirements greatly decreased the REIT's 1973 earnings.[80] With the decrease in earnings came a fall in stock prices and a loss of favorable ratings for debt issues, which effectively foreclosed most REITs from the capital market.[81]

The first crisis that appeared for REITs as a result of this "cash crunch" was the possibility that they would be forced to default on approximately $4 billion of short-term commercial paper.[82] While the banking industry was reluctant at first to help the REIT industry refinance its commercial paper,[83] many large loans were made in response to pressure from the Federal Reserve Board.[84] In addi-

75. Robertson, *supra* note 22, at 115; *When Is a Lemon A Lemon?*, *supra* note 17.

76. Robertson, *supra* note 22, at 114-15.

77. Lurov, *supra* note 34.

78. On December 27, 1973, the various real estate interests of Walter J. Kassuba, which together made up one of the largest real estate "empires," filed for protection under Chapter 11. Included in the list of creditors were at least a dozen REITs with claims of over $110 million. *Kassuba Is Said to Have Loans Outstanding of $110 Million by About 12 Realty Trusts*, Wall St. J., Dec. 28, 1973, at 7, col. 1.

79. *Auditors Ask Northern States Mortgage Trust For Some Reappraisals*, Wall St. J., Mar. 27, 1974, at 11, col. 1; *Audits Become Painful for Some REITs That Focus on Mortgage, Building Loans*, Wall St. J., Mar. 14, 1975, at 22, col. 1.

80. *Capital Mortgage Says Second Period Earnings Will Fall Substantially*, Wall St. J., June 27, 1974, at 8; *For '73 First Wisconsin Mortgage Trust Finally Posts $2.3 Million Loss*, Wall St. J., Sept. 3, 1974, at 19, col. 1.

81. In 1974, eighteen of the twenty biggest losers on the New York Stock Exchange were REITs, and among them were the five largest REITs. Robertson, *supra* note 22, at 114. For a discussion of the withdrawal of ratings on REIT debt issues see *Bank America Realty and IDS Realty Lose Moody's Paper Rating*, Wall St. J., Feb. 21, 1975, at 4, col. 1.

82. Robertson, *supra* note 22, at 113.

83. *Id.*

84. A former member of the Federal Reserve Board testified to the House Banking

tion, many REITs were able to convince their creditor banks to execute "revolving credit agreements" that would combine the resources of the banks in new lines of credit and orchestrate their repayment.[85] Many banks refused to join in such agreements, however, sometimes successfully bringing suit to recover their loans or foreclose on their security.[86] Many other REITs were simply unable to negotiate a workable arrangement with creditor banks and were forced during 1974 and 1975 to seek protection in Chapter 11 of the Bankruptcy Act.[87]

For many banks, however, Chapter 11 or any other orderly liquidation procedure was the last alternative they wanted the REITs to choose. Any such procedure would require the banks to recognize huge losses on the loans that had been made to REITs, which would have greatly impaired the banks' ability to raise capital and cast doubt on their financial strength in the eyes of the banking community.[88] Pride was also at stake for many of these banks, because the most troubled REITs often were sponsored by a major bank and bore the same name.[89] As a result, many of the major banks began

Committee in February of 1975 that the "Fed's" directors were afraid that a series of REIT failures would lead to a financial panic. *Bad Investments*, *supra* note 71.

85. *See, e.g.*, *Barnett REIT Gets Credit Pact for $183 Million*, Wall St. J., Feb. 12, 1975, at 6, col. 1; *First Mortgage Gets $400 Million of Credit From 100—Bank Group*, Wall St. J., June 27, 1974, at 18, col. 1; *Security Mortgage Sets One-Year Accord With Lending Banks*, Wall St. J., Nov. 25, 1974, at 30, col. 1.

86. *See, e.g.*, Robertson, *supra* note 22, at 172-73; *IDS Realty Trust Sued By Creditor Seeking $10 Million Payment*, Wall St. J., Mar. 22, 1976, at 10, col. 1; *Security Mortgage Says Banks Are Calling $96.1 Million of Debt*, Wall St. J., Oct. 17, 1974, at 35, col. 1.

Problems with a "hold-out" bank can also of course arise after a credit arrangement has been negotiated with several banks. For example, Fidelco Growth Investors was recently forced into a default when one of the banks refused to go along with a proposed one-year reduction in interest payments. Wall St. J., Jan. 10, 1978, at 1, col. 2.

87. *See, e.g.*, *A REIT Files for Protection Under Chapter 11*, Wall St. J., Mar. 18, 1974, at 5, col. 1; *Chapter 11 Status For Continental Trust Is Sought*, Wall St. J., Mar. 9, 1976, at 5, col. 1; *Fidelity Mortgage Files for Protection Under Chapter 11*, Wall St. J., Jan. 31, 1975, at 4, col. 2. In such a situation, it is always possible that the Securities and Exchange Commission (SEC) may move for a transfer of the petitions to Chapter 10, if there exist many public shareholders and a complex financial structure. Such a transfer would place control of an REIT's assets in the hands of a court-appointed trustee and might in fact *not* be in the shareholders' interests if the trustee is not experienced in real estate finance. *See, e.g.*, *SEC Moves to Switch Continental Mortgage REIT Into Chapter 10*, Wall St. J., May 10, 1976, at 10, col. 1.

88. For example, one of the nation's largest banks was forced to call off the sale of convertible debentures due to the widespread concern in the investment community over the bank's loans to several troubled REITs. *Chemical Bank Parent Cancels Debt Sale Due to Investor Concern Over REIT Loans*, Wall St. J., Mar. 31, 1975, at 3, col. 1.

89. Samuelson, *Troubled Friend at Chase Manhattan*, THE NEW REPUBLIC, Nov. 15, 1975, at 13-15.

in late 1975 to negotiate a purchase of properties and loans held by REITs in return for cash payments badly needed by the REITs.[90] Many other creditor banks later effected an exchange of REIT properties and loans for a cancellation of debt owed to the bank (hereinafter referred to as a SWAP).[91] While the Securities and Exchange Commission (SEC) expressed extreme displeasure at these transactions,[92] SWAPs appeared to be the perfect solution for creditor banks—REIT properties and loans were transferred to the bank and recorded at the high market value of previous years, so that no losses were suffered by banks on the cancellation of debt,[93] and the banks ended up with title to specific assets on which management expertise and local market knowledge could be brought to bear.[94] Such an exchange also greatly benefited the REIT—any "cancellation of indebtedness" income[95] boosted the REIT's earnings, with no adverse tax effects because of such an REIT's normal loss position, which consequently increased earnings per share and the equity/debt ratio, thereby improving the REIT's chances of raising new capital.

Those REITs that could not negotiate these arrangements with their creditor banks found themselves in 1976 totally controlled by the banks as consideration for the large loans made to keep the REIT afloat.[96] The problems were often compounded by shareholders and noteholders who refused to allow their trustees to pledge assets to their creditor banks, and who demanded other actions from

---

90. *See, e.g., Builders Investment Says It Sold Creditors $14.5 Million of Loans*, Wall St. J., Apr. 23, 1975, at 17, col. 1; *Chase REIT Discloses a Program to Sell $150 Million of Its Assets to Chase Bank*, Wall St. J., Sept. 16, 1973, at 6, col. 1.

91. *See, e.g., Barnett Mortgage Gets Bank Accords on SWAP of $82.1 Million Assets*, Wall St. J., Nov. 20, 1975, at 34, col. 1; Stuart, *Realty Trusts Try to Reduce Debt With Asset Swaps*, N.Y. Times, Nov. 24, 1975, at C 53, col. 1.

92. The SEC's main concern was that the losses realized by the banks on their REIT investments might be concealed from investors by these transactions. *See Realty Trusts Raise Cash, Repay Bankers By Giving Up Assets*, Wall St. J., Jan. 5, 1976, at 1, col. 1; *SEC 'Sleeper' on Swaps of REIT Assets May Cause Banks to Halt Such Programs*, Wall St. J., Mar. 30, 1976, at 15, col. 1.

93. See text accompanying notes 174-75 *infra* for a discussion of this particular objective of the transaction.

94. It would seem that banks would be more satisfied with an arrangement of this sort because their ability to protect their investment is much less under the other alternative—remaining the holder of a small undivided interest in every asset of the REIT.

95. I.R.C. § 611(a)(12). The amount of income recognized by the REIT would of course depend on how far its basis in the assets transferred had been written down by previous charges to income that reflected the decreasing value of the underlying debt.

96. Carberry, *Banks Seek to Impose Tough Conditions on Troubled REITs; Some Holders Rebel*, Wall St. J., June 1, 1977, at 34, col. 1.

the trustees to protect the holders' investments.[97] The cumulative effect of these developments continued to force REITs into Chapter 11 of the Bankruptcy Act, as the pressures from lendor banks and noteholders began to reduce management discretion to an unacceptable level.[98] By mid-1977, it appeared that only a few REITs, most of them equity or long-term mortgage trusts, remained as viable entities with a realistic future as an investment vehicle.[99] It seems certain, however, that those REITs that have disposed of their foreclosed properties, reduced their substantial bank debt, and obtained fresh sources of capital, have an excellent chance of gaining a share of the prosperity offered by a reviving real estate market.

IV. Present Regulation of REITs and Existing Avenues of Redress for Their Shareholders

While there was enacted no general regulatory scheme for the REIT industry upon its creation in 1960, it would seem that REITs would be subject to the provisions of several federal statutes.[100] The objective of this section is to examine the actions brought under these statutes in order to determine whether their application has provided sufficient regulation of the REIT industry and effective protection for those who have invested their capital in it. No part of this discussion is meant to imply that a special exception should be made for REITs within each statute; rather, this discussion will suggest that the present "patchwork" regulation by many statutes

97. *Id.*; *Small Bondholders Threaten to Scuttle Realty-Trust Rescue*, Wall St. J., Oct. 28, 1975, at 1, col. 1 (bondholders refused to accept less than face value in proposed redemption of their indentures, which would have given creditor banks an unchallenged security interest).

98. *Justice Mortgage Files for Court Protection Under Bankruptcy Act*, Wall St. J., Jan. 3, 1978, at 8, col. 4 (before succumbing to pressures from various interested parties, this Texas REIT tried an asset exchange program with its lendor banks and a tender offer to its noteholders).

99. Carberry, *Improved Pictures for Some REITs Prompts Analysts to Look at Speculative Investments*, Wall St. J., Aug. 29, 1977, at 23, col. 1; *Troubled REITs Face Added Uncertainties As Notes Come Due*, Wall St. J., Aug. 27, 1976, at 1, col. 1.

100. While it is beyond the scope of this article to analyze the various state common law causes of action that may be available, it should be noted that an REIT shareholder should have a viable cause of action should he allege self-dealing by REIT trustees, excessive compensation for the investment adviser, diversion of business opportunity from the REIT, failure of the adviser to render impartial advice, or sale of the adviser's office. *E.g.*, Greenspun v. Bogan, 492 F.2d 375 (1st Cir. 1974); Scheinbart v. Certain-teed Prods. Corp., 367 F. Supp. 707 (S.D.N.Y. 1973); Schreiber v. Northwestern Mut. Life Ins. Co., 361 F. Supp. 625 (S.D.N.Y. 1973).

is not sufficient and certainly not as efficient as would be one regulatory statute enacted specifically for the REIT industry.

A. *The Internal Revenue Code*

When one is searching for regulatory provisions affecting a particular industry, the initial inquiry should, of course, focus upon the statute that created that industry. While section 856 of the Internal Revenue Code establishes many tests that an REIT must meet annually in order to qualify for its special tax treatment,[101] the overall objective of these tests is to ensure that the REIT is truly acting as a mere conduit for the pass-through of real estate investment income to many small investors and not to regulate the conduct of the industry.[102]

---

101. See note 4 *supra* for a discussion of these tests.

102. While it is the purpose of this article to discuss the possible regulation of REITs as an investment vehicle, and not the tax rules which should be applied to the industry, it should be noted that the Tax Reform Act of 1976 made many significant changes in the tax rules applicable to REITs. The Act climaxed an effort of several years by the National Association of Real Estate Investment Trusts to reduce the inflexibility of the statutory framework that had existed before and to make compliance with the various statutory requirements much easier for the average REIT. See a report by G.N. Buffington, Executive Vice President and General Counsel of the National Association of Real Estate Investment Trusts, reported at 4A R. POWELL, THE LAW OF REAL PROPERTY ¶ 573C[4][e] n.106 (Rohan ed. 1977). See also Statement by Congressman Landrum in sponsoring H.R. REP. No. 11083, 93d Cong., 1st Sess., 119 CONG. REC. 34930 (1973) (1973 legislation which was later adopted as part of the TRA); H.R. REP. No. 94-658, 94th Cong., 1st Sess. 354 (1976) and S. REP. No. 94-938, 94th Cong. 2d Sess. 462 (1976) (reports of the House Ways and Means Committee and Senate Finance Committee on the TRA).

Some of the provisions of the Act that were quite favorable for the REIT industry are as follows:

1) where underdistribution of dividends is inadvertent, the REIT will no longer be disqualified from treatment as a conduit (no corporate tax), but will be allowed to pay additional dividends which will relate to the year in question. I.R.C. § 859.

2) REITs will no longer be disqualified by holding property primarily for sale to customers, but will instead suffer a 100% tax on any such income, a small price compared to taxation of an REIT's entire income upon disqualification. I.R.C. § 856(c)(7).

3) REITs will no longer be disqualified when they inadvertently fail to meet either the 90% or 75% income source test; only a confiscatory tax on the REIT's net income attributable to the amount by which it failed either of the tests will be imposed. I.R.C. § 856(c)(7).

4) In meeting the "source of income" tests, an REIT may include rentals from incidental personal property. I.R.C. § 856(d)(1).

5) Also included in meeting the "source of income" test now are commitment fees. I.R.C. §§856(c)(2)(G)-(3)(G).

6) REITs may now incorporate, which eliminates many of the burdens formerly borne by REITs. I.R.C. § 856(a).

7) Net operating losses may now be deducted by REITs. Section 1606(a) of the Tax

It was argued for a brief time, however, that one provision of section 856 could require that an REIT's trustees be completely independent of the trust's investment adviser.[103] That provision of section 856 provided that the trustee of an REIT could not be an officer or employee of, or have any proprietary interest in, any "independent contractor" that furnishes services pertaining to trust property, or who manages or operates such property.[104] This requirement seemed to have as its objective, however, not the elimination of a potential conflict of interest, but rather the guarantee that an REIT would act only as the "conduit" collector of passive real estate investment income and not the active manager of real estate properties or the vendor of associated service functions.[105] So long as the investment adviser is not providing services to tenants,[106] or actively managing the real estate property itself,[107] it would appear that section 856 would not forbid the affiliation of an REIT trustee with the trust's investment adviser. It would appear, therefore, that the Internal Revenue Code provides little if any regulatory framework for the conduct of an REIT.

B. *The Investment Company Act of 1940*

Despite the fact that REITs are basically mutual funds with a portfolio consisting of interests in real estate instead of in shares of stock or other securities, it has been long acknowledged that REITs are excluded from the definition of an investment company.[108] Thus, the Investment Company Act of 1940 has no application to the REIT. Nevertheless, while the SEC has found that the REIT indus-

---

Reform Act struck out I.R.C. § 857(b)(2)(E), which previously prevented such a deduction.

8) REITs will no longer have to pay a capital gains tax when an overall loss for the year is suffered. I.R.C. §§ 857(B)(2)-(3)(G).

103. Parker, *REIT Trustees and the "Independent Contractor,"* 48 VA. L. REV. 1048 (1962).

104. Treas. Reg. § 1856-1(d)(1)(1967).

105. Kahn, *Taxation of Real Estate Investment Trusts*, 48 VA. L. REV. 1011, 1020 (1962).

106. Carroll, *Tax Policy for the Real Estate Investment Trust*, 28 TAX. L. REV. 299, 336-40 (1973).

107. Kelley, *Real Estate Investment Trusts After Seven Years*, 23 BUS. LAW. 1001, 1006-07 (1968).

108. Note, *supra* note 39, at 615. This opinion is based upon section 3(c)(5)(C) of the Act, which excludes from the definition of investment company any person who is primarily engaged in the business of "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate". *Id.*

try is not in need of a comparable regulatory framework,[109] some commentators have called for a regulatory scheme similar to that of the Investment Company Act.[110]

C. *The Securities Act of 1933*

Because REITs depend a great deal upon periodic infusions of cash from the equity markets,[111] it would seem that the disclosure requirements and protections of the Securities Act of 1933[112] ('33 Act) could play an important role in controlling some of the major abuses within the REIT industry.[113] Indeed, causes of action against REITs under sections 11 and 17 have been upheld by several courts.[114]

There exist several problems, however, with respect to reliance upon these sections to provide a sufficient check upon the activities of an REIT. First of all, these sections operate only to require complete and accurate disclosure of all material information in connection with an offering of securities, whether registered[115] or unregistered.[116] An REIT may continue to maintain a situation that constitutes a plain conflict of interest, for example, so long as the existence of that conflict is disclosed. Given the large number of REITs that were affiliated with their investment advisers,[117] which did not appear to adversely affect the REIT's ability to raise capital,[118] it

---

109. The SEC's Real Estate Advisory Committee concluded in late 1972 that "there has not been demonstrated need in the real estate field for substantive federal regulation similar to that provided by the Investment Company Act of 1940." [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,265. However justifiable this conclusion may have been in 1972, there has been a great deal of history that has transpired in the REIT industry since that time, most of that history a sad one. It is of course the position of this article that a regulatory framework is required in order to prevent a financial disaster of the kind suffered by the REIT industry from ever happening again. See the text accompanying notes 158-214 *infra* for a discussion of the general form such a regulatory scheme should take.

110. Rosenblatt & Lybecker, *supra* note 10, at 686.

111. *REITs Face Shake-Out As Investments Sour, Cash Sources Dry Up*, *supra* note 4.

112. 15 U.S.C. §§ 77a-77aa (1970).

113. Lynn, *Real Estate Investment Trusts: Problems and Prospects*, 31 FORDHAM L. REV. 73 (1962).

114. *See, e.g.*, Kusner v. First Pa. Corp., 395 F. Supp. 276 (E.D. Pa. 1976); Byrnes v. IDS Realty Trust, 70 F.R.D. 608 (D. Minn. 1976).

115. Section 11 of the '33 Act by its terms applies only to untrue statements of material fact or omissions of material information in an effective registration statement. Securities Act of 1933 § 11(a), 15 U.S.C. § 77k (1970).

116. Section 17(a) applies to all offers or sales of securities, notwithstanding the fact that they may be exempted from registration by section 3 of the '33 Act. *See also* the Securities Act of 1933 § 12(2), 15 U.S.C. § 77l (1970).

117. See notes 20-22 *supra* and accompanying text.

118. Some of the largest and most successful REITs were affiliated in some way with

would seem that required disclosure of these conflicts would not force elimination of that conflict.

It is clear, however, that rigorous application of sections 11 and 17(b) could serve to protect the public from one very common abuse in the REIT industry, that of not maintaining an adequate loan-loss reserve.[119] Had disclosure relating to "problem loans" and foreclosures been made, the investing public certainly would not have paid the amounts they did for REIT stock and debentures. Even in such situations, or in those similar to it, however,[120] there exist barriers to successful suit by an aggrieved plaintiff. The reasonable care defenses of section 11[121] and the scienter requirement of section 17(a)(1)[122] prevent these sections from providing sufficient protection for REIT investors.

D. *Anti-Fraud Provisions of the Securities Exchange Act of 1934*

As is the case with securities litigation in general today, most plaintiff REIT investors seem to allege a violation of section 10(b)[123]

---

their investment adviser. For example: Chase Manhattan Mortgage & Realty Trust (investment adviser—Chase Manhattan Bank), Connecticut General Mortgage & Realty Investments (investment adviser—a subsidiary of Connecticut General Life Insurance Co.), and Citizens & Southern Realty Trust (investment adviser—Citizens & Southern National Bank). Biderman, *supra* note 6. In fact, one of the reasons for the success (for a time) of these REITs may have been a feeling on the part of the investment community that the sponsor-investment adviser would be a source of ready cash when financial adversity struck.

119. See text accompanying notes 78-81 *supra*.

120. Another disclosure which might have had an effect would have related to the foreclosures made by REITs and the value to the REIT of those properties. *See When Is a Lemon a Lemon?*, *supra* note 18.

121. Under section 11, the directors, accountants, and underwriters connected with a false or misleading registration statement may establish a defense if they have exercised varying degrees of reasonable care. Escott v. Bar Chris Construction Corp., 283 F. Supp. 643, 683-703 (S.D.N.Y. 1968); Folk, *Civil Liabilities Under the Federal Securities Acts: The Bar Chris Case*, 55 VA. L. REV. 1 (1969).

122. Assuming that a private right of action does exist under § 17(a), which has been disputed, Dyer v. Eastern Trust & Banking Co., 336 F. Supp. 890 (D. Me. 1971), a showing of a scienter should be required, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968)(Friendly, J., concurring), *cert. denied sub nom.* Kline v. SEC, 394 U.S. 976 (1969), especially in light of the similarity in language between § 17(a) of the Securities Act and § 10(b) of the Exchange Act, 15 U.S.C. §§ 77q, 78j (1970), which the Supreme Court held to require a showing of scienter. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), *noted in* 8 TEX. TECH L. REV. 539 (1976).

123. That portion of the '34 Act makes it unlawful for any person:

> To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1970).

of the Securities Exchange Act of 1934 ('34 Act) by the trust's adviser, trustees, and accountants. For example, in *Byrnes v. IDS Realty Trust,*[124] section 10(b) was used to obtain damages resulting from the purchase of an REIT security following a news release by an REIT. The release claimed that earnings for the previous year would be substantial, that only a small addition to the loan-loss reserve would be required, and that the REIT's non-earning assets total was a manageable one.[125] The completed financial statements released approximately two months later instead showed a substantial loss for the year, an addition to the loan-loss reserve four times greater than that specified in the release, and a non-earning asset total over three times greater.[126]

Likewise, in *Morkewich v. Adikes,*[127] section 10(b) was relied upon by an REIT shareholder who claimed that the REIT's trustees, adviser, and accountant had entered into a complicated plan to conceal from the REIT's shareholders and the investing public the true financial condition of the REIT. In a similar suit, *Blumenthal v. Great American Mortgage Investors,*[128] the plaintiff alleged that an REIT had misrepresented that it investigated the economic soundness of developers and their investments before making a loan, and that the REIT advanced funds to developers over the amount of an initial loan so as to conceal the fact that the developers were in default of the initial loan.

There exist several barriers, however, to successful completion of a suit under section 10(b) by an REIT shareholder. For example, in *Kusner v. First Pennsylvania Corp.,*[129] the district court held that a plaintiff debenture holder, who was alleging that the REIT's adviser had fraudulently diverted investment opportunities away from the REIT, did not have standing to bring a derivative suit under Federal Rule of Civil Procedure 23.1, because he was not a share-

124. 70 F.R.D. 608 (D. Minn. 1976).
125. *Id.*
126. *Id.* at 610-11. The numerical details can be summarized as follows:

	Per 2/14/75 Release	Per Financial Statement
Earnings	$7.2 million income	$5.1 million loss
Allowance for Loan Loss	3.9 million	16.7 million
Non-earning Assets	29.6 million	92.0 million

127. 422 F. Supp. 1144 (E.D.N.Y. 1976). The plaintiff in this case, a shareholder in BT Mortgage Investors (BTMI), was suing BTMI's trustees, its advisers, and Peat, Marwick & Mitchell, BTMI's accountants.
128. 74 F.R.D. 508 (N.D. Ga. 1976).
129. 395 F. Supp. 276 (E.D. Pa. 1975), *rev'd in part*, 531 F.2d 1234 (3d Cir. 1976).

holder. While this holding was reversed on appeal,[130] the Third Circuit based its reversal on the fact that the plaintiff's debenture was convertible into stock, and noted in dicta that the holder of a debenture without such a feature would not have standing.[131] These holdings eliminate from the class of potential plaintiffs a great number of public investors who purchased junior debentures issued by REITs.[132]

Of much more serious concern to REIT investors is the possibility that even if they can establish that a violation of section 10(b) has occurred, they may be unable to recover damages. This result can obtain when it becomes necessary for the plaintiff to show that the violation of section 10(b) by the defendants caused the damage suffered by the plaintiffs.[133] After all, as one district court observed, "[v]ast losses that have been incurred by REITs and other segments of the real estate industry could cause the finder of fact to conclude that plaintiff's losses were not the result of defendant's violation of the securities laws."[134] The practical effect of requiring the plaintiff to prove causation would be to provide immunity to REIT trustees or advisers who have violated the securities laws through fraud and self-dealing and have thus reduced the value of shareholders' investments, so long as other trustees and advisers have taken the same actions, leading to deterioration of the entire industry.

E. The Proxy Rules of the Securities Exchange Act of 1934

Pursuant to the rule-making authority granted it by section 14(a) of the '34 Act, the SEC has promulgated Rule 14a-9, which prohibits the use of false and misleading statements in proxy solicitations.[135] Because REIT trustees made use of proxy solicitations when it came time for shareholders to re-elect or reject their trustees, some plaintiff REIT shareholders alleged that the failure of

130. Kusner v. First Pa. Corp., 531 F.2d 1234 (3d Cir. 1976).

131. *Id.*

132. See note 18 *supra* and accompanying text.

133. For a discussion of the causation showing required by a suit under a § 10(b), see A. Bromberg, Securities Law, Fraud, SEC Rule 10b-5 § 8.7 (1974).

134. Kusner v. First Pa. Corp., 74 F.R.D. 606, 609 (E.D. Pa. 1977).

135. Rule 14a-9(a) forbids the use of a proxy solicitation that contains:

> [A]ny statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state a material fact necessary in order to make the statements therein not false or misleading . . . .

trustees to disclose that they had engaged in self-dealing and other breaches of fiduciary duty was a violation of section 14(a) and Rule 14a-9(a).[136] While the approaches taken to a resolution of this question vary, the courts have been unanimous in rejecting attempts to establish a cause of action. For example, in *Morkewich v. Adikes,*[137] the district court noted that section 14(a) has been applied only to proxies concerning corporate mergers or acquisitions, or concerning the qualifications of trustees, and held that the proxy rules are not violated simply because the prior trustees have mismanaged and the proxy solicitations do not disclose that fact.[138] In *Perelman v. Pennsylvania Real Estate Investment Trust,*[139] another district court took a more realistic approach, noting that the existence of a conflict of interest and self-dealing with regard to trustees up for reelection would certainly be material for purposes of section 14(a). The court held, however, that no violation had occurred because the information omitted was not needed to make statements made in the proxy solicitation not false or misleading.[140]

F. *The Investment Advisers Act of 1940*

It was the intent of Congress in 1940 that persons who paid for investment advice be protected from dishonest and self-dealing advisers.[141] To provide this protection, Congress enacted section 206 of the Investment Advisers Act of 1940.[142] The Advisers Act makes it unlawful for any investment adviser:

> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
> (2) to engage in any transaction, practice, or course of business

---

136. *See, e.g.*, Perelman v. Pennsylvania Real Estate Inv. Trust, 432 F. Supp. 1298 (E.D. Pa. 1977); Markewich v. Adikes, 422 F. Supp. 1144 (E.D.N.Y. 1976).

137. 422 F. Supp. 1144 (E.D.N.Y. 1976).

138. *Id.* at 1147.

139. 432 F. Supp. 1298, 1304 (E.D. Pa. 1977).

140. Rule 14a-9(a) does not require that all material information be disclosed in a proxy solicitation, but only those facts "necessary in order to make the statements therein not false or misleading." Therefore, it would seem that a trustee would be required to disclose self-dealing or other acts of mismanagement only if he had represented in the proxy solicitation that he was honest or a good manager.

141. Bolger v. Laventhol, Krekstein, Horwath & Horwath, 381 F. Supp. 260, 263 (S.D.N.Y. 1974).

142. 15 U.S.C. §§ 80b-1 - 80b-21 (1970 & Supp. 1975). For a general discussion of the Advisers Act see Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214 (1959).

> which operates as a fraud or deceit upon any client or prospective client;[143]

Because an REIT's adviser would seem to be expressly covered by the Advisers Act,[144] many REITs filed suit under section 206 claiming that the advisers mismanaged the REIT and gave faulty advice.[145] As with the Securities Acts, however, there are many obstacles that stand in the way of a plaintiff pursuing such a cause of action.[146]

A plaintiff attempting to file suit under section 206 must first convince the court that an implied right of action exists for him, because an express right is not conferred.[147] While the weight of authority holds that such an implied right does exist,[148] there are some decisions to the contrary.[149]

Another problem faced by an REIT investor in pursuing a suit under section 206 is that he must show more than mere mismanagement—he must show some kind of fraudulent conduct, such as misrepresentation or concealment.[150] Allegations that an advisory contract is unfair, that the adviser's compensation is excessive, that purchases for the REIT's portfolio were at an unfair price, or that certain loans by the REIT were unfair, have been held insufficient to establish fraudulent conduct.[151]

It is also clear that an REIT investor may not sue on his own

---

143. 15 U.S.C. § 80b-6(1)-(2) (1970).

144. 15 U.S.C. § 80b-2(a)(11) (1970).

145. *E.g.*, Gross v. Diversified Mortgage Investors, 431 F. Supp. 1080 (S.D.N.Y. 1977).

146. See text accompanying notes 147-158 *infra*.

147. Section 206 of the Advisers Act simply makes certain practices "unlawful". 15 U.S.C. § 80b-6 (1970).

148. *See, e.g.*, Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977); Jones v. The Equitable Life Assurance Soc'y of the United States, 409 F. Supp. 370 (S.D.N.Y. 1975); The Fund of Funds, Ltd. v. Vesco, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,644 (S.D.N.Y. 1975); Bolger v. Laventhol, Krekstein, Horwath & Horwath, 381 F. Supp. 260 (S.D.N.Y. 1974).

149. *E.g.*, Greenspan v. Del Toro, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,488 (S.D. FLA. 1974).

It would seem that the more reasonable position would be that which implies a right of action. Certainly those persons who allege that they have been defrauded by their investment adviser fall within the class of persons about whom Congress was concerned when enacting section 206, and granting these persons damages when they have been wronged would also encourage compliance by advisers with section 206.

150. *See* Jones Memorial Trust v. TSAI Inv. Servs., Inc., 367 F. Supp. 491 (S.D.N.Y. 1973). *See also* Kutner v. Gofen & Glossberg, [1971-72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,109 (7th Cir. 1971).

151. Jones v. The Equitable Life Assurance Soc'y of the United States, 409 F. Supp. 370 (S.D.N.Y. 1975).

behalf. Because section 206 speaks in terms of a fraud upon an adviser's "client or prospective client," which is the REIT itself and not the investor,[152] to maintain an action against an adviser, the investor must bring the action derivatively on behalf of the REIT. Another problem arises here, however, because under state law, which is generally followed by federal courts in this situation,[153] a plaintiff suing derivatively must first make a demand on the REIT's trustees that they bring suit.[154]

While this requirement would not seem to place an onerous burden upon a plaintiff shareholder, it can actually effectively foreclose the plaintiff from pursuing his action—under the business judgment rule, if the independent directors of a corporation choose not to bring suit after a demand is made upon them, the plaintiff shareholders may not pursue their suit unless they can show a lack of good faith on the part of the directors.[155] In applying this concept to a suit filed under section 206, the district court in *Lasker v. Burks*,[156] stated:

> [A]bsent a statutory exception . . . the directors of a corporation should be given the chance to perform their duties . . . including whether to prosecute a cause of action. If they have exercised their business judgment in good faith then a decision not to sue should be final.[157]

It would therefore seem that reliance on section 206 of the Advisers Act to provide adequate protection for REIT investors would not be warranted.

G. *Summary*

It should be clear that existing statutory law does not provide the regulation necessary for adequate protection of REIT investors, much less the framework that would direct the smooth functioning

152. Gross v. Diversified Mortgage Investors, 431 F. Supp. 1080, 1095 (S.D.N.Y. 1977).

153. Brody v. Chemical Bank, 482 F.2d 1111 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973).

154. Magid v. Mortgage Growth Investors, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,673, at 90,314 (S.D.N.Y. 1976); Jones v. The Equitable Life Assurance Soc'y of the United States, 409 F. Supp. 370 (S.D.N.Y. 1975).

155. Lasker v. Burks, 404 F. Supp. 1172 (S.D.N.Y. 1975).

156. *Id.* at 1172 (S.D.N.Y. 1975).

157. *Id.* at 1179. The derivative suit of a mutual fund's shareholders was dismissed by the court because the fund's independent directors had unanimously determined that a suit against the fund's adviser would be contrary to the best interests of the fund and its shareholders.

of the REIT industry. Existing statutory law obviously did nothing to prevent the financial disaster that occurred within the REIT industry, and an analysis of the suits brought thereafter by REIT investors indicates that the public is not obtaining any satisfaction for the damages they have suffered. Consequently, the remainder of this article will be devoted to proposals for legislative change that would hopefully fill the void that now exists.

V. A Proposed Regulatory Framework for the Reit Industry

It will be the objective of this section to propose the general form of legislation which should be adopted in order not only to allow REIT investors effective access to the courts when they have been wronged, but to ensure that many of the problems which caused the REIT's decline do not occur again. While some of the suggestions are directed to the need for more complete and accurate disclosure in the industry, the purpose of most will be to provide well-defined standards that must be met by every member of the industry.

A. *Shareholder Rights and Control Over the REIT*

It could be safely asserted that one of the most respected principles of modern securities regulation is the requirement that overall corporate management be subject to the approval of the corporation's ultimate owners through periodic elections.[158] Such shareholder rights ensure that corporate management will remain ever mindful that their actions should always be in the best interests of shareholders.[159] These principles should be equally applicable to REITs, so that shareholders should have the power to:

(1) elect the trustees annually;
(2) remove trustees for just cause;
(3) amend the trust articles;[160] and
(4) terminate the trust.[161]

---

158. Rules 14a-1 to 14a-12 of the Securities Exchange Act of 1934.

159. *See generally*, Eisenberg, The Structure of the Corporation, 37-63 (1976).

160. Such a power would allow shareholders to authorize incorporation of an REIT so as to utilize tax losses and manage foreclosed properties. *See Palomar Mortgage Planning to Abandon Its Status as a Trust*, Wall St. J., Aug. 21, 1974, at 4, col. 1. The Tax Reform Act of 1976 specifically allows the incorporation of REITs. Tax Reform Act of 1976 § 1604(F)(1), *amending* I.R.C. § 856(a).

161. The grant of the above should be consistent with the spirit of the Internal Revenue Code requirements, so long as the trustees retain such rights and powers as will meet the

This power on the part of REIT shareholders is even more desirable than it would be for mutual funds, for example, because mutual funds shareholders can usually show their displeasure over management by redeeming their shares, which reduces the investment adviser's fee.[162] While the shareholders of listed REITs possess a right of sale that is equivalent to that of redemption, many shareholders of unlisted REITs would face great difficulty in liquidating their investments, and even sales by listed REIT shareholders would not greatly concern an adviser, because those sales do not reduce REIT assets but simply substitute a new owner in the old shareholder's place. In any case, the use of such a redemption feature would be impractical for REIT shares because of the illiquidity of an REIT's portfolio and the probable necessity of conducting constant independent appraisals in order to establish share value.[163]

The grant of such powers to shareholders is not without its problems however. Under the common law of several states, the grant of too much control to trust beneficiaries will cause the trust to be treated as a partnership, so that the shareholders of an REIT could face unlimited liability for the debts of an insolvent REIT.[164] While this risk might be minimized or even eliminated by the inclusion of a clause in all REIT contracts and borrowing agreements that no shareholder liability will exist,[165] the best solution is to incorporate, which REITs are now allowed to do.[166]

B. *Self-Dealing and Over-Reaching*

There are obviously many conflicts of interest that can arise from the investment adviser—REIT relationship. It has been argued, for example, that sponsor-advisers often passed investment opportunities to their REITs that were too risky for the adviser to

---

"centralization of management" requirements of Treas. Reg. § 301.7701-2(c) (1970). Treas. Reg. § 1.856-1(d)(1) (1978).

162. Because the advisers fee for mutual fund advisers is usually a percentage of the fund's assets, the redemption of his shares by a shareholder will reduce the amount paid to the fund's adviser.

163. Sobieski, *State Securities Regulation of Real Estate Investment Trusts*, 48 VA. L. REV. 1069 (1962).

164. 4A R. POWELL, REAL PROPERTY § 573A-1, at 463 (1972); Note, *Liability of Shareholders in a Business Trust—The Control Test*, 48 VA. L. REV. 1105 (1962); *REITs Face Shake-Out As Investments Sour, Cash Sources Dry Up*, *supra* note 4.

165. Sobieski, *supra* note 163.

166. The Tax Reform Act of 1976, however, does allow REITs to incorporate. The Tax Reform Act of 1976 § 1604(f)(1), *amending* I.R.C. § 856(a). See note 15 *supra*.

handle.[167] In addition, there have been reported many instances where an REIT has dealt with trustees or parties related to them on terms that were less than arms-length.[168] While potential conflicts can be disclosed in a prospectus, the effect of such disclosure is probably minimal,[169] and it has been held by several courts that self-dealing can actually be authorized in a trust instrument.[170] Therefore, to eliminate some of the danger that such abuses will occur, the following suggestions are made:

(1) Independent trustees. The majority of an REIT's trustees should be unaffiliated[171] with the investment adviser, and any purchase or sale transaction with the adviser or any trustee should be approved by both a majority of the trustees and a majority of the independent trustees.[172] In addition, independent appraisals should be performed on all property concerned, to ensure that the terms of the transaction are fair.[173] Not only would such provisions protect the REIT from unfair transactions, but they would also force the adviser to recognize any loss realized on a SWAP[174] so that its investors would not be deceived.[175]

(2) Deduction of commissions from adviser's fee. The collection of commissions earned by an adviser from services rendered on a particular transaction is excessive because it usually constitutes payment twice for the same service.[176] Therefore, all commissions

167. *See, e.g., Real Estate Trusts Feud with Advisers Over Their Obligations*, Wall St. J., Mar. 13, 1975, at 1, col. 1.

168. *Class Action Is Filed Against U.S. Realty Investments, Officers*, Wall St. J., Aug. 11, 1975, at 4, col. 1; *D-Z Investment Asks Court to Postpone NJB Annual Meeting*, Wall St. J., June 4, 1974, at 19, col. 1.

169. Note, *supra* note 39, at 619-20.

170. Cohen v. U.S. Trust Sec. Corp., 311 Mass. 152, 40 N.E.2d 282 (1942).

171. The definition of "affiliated person" used by the Investment Company Act, which includes within that term officers, directors, employees, of five percent owners of the transacting person, could probably be adopted for use in this situation. See the Investment Company Act of 1940 § 2(a)(3), 15 U.S.C. § 80a-2 (1970). It is the opinion of the author that the "interested person" definition of § 2(a)(19) of the Act is much too broad and the standards to be used in application of the definition too ambiguous.

172. *See generally* Midwest Securities Commissioners Association, Statement of Policy on Real Estate Investment Trusts adopted on July 16, 1970, 1 BLUE SKY LAW REP. ¶ 4801 (1970) [hereinafter cited as Midwest Statement]. *See also Citizens and Southern Realty Settles Suit by Agreeing Not to Break Securities Law*, Wall St. J., April 24, 1978, at 15, col 1 (SEC required majority of independent trustees in consent decree).

173. Midwest Statement, *supra* note 172, § B(4).

174. See text accompanying notes 90-95 *supra*.

175. If a bank cancels debt in an amount greater than the value of the loan or real estate received, the operation of elementary accounting principles will result in a loss showing up on the bank's financial statement somewhere.

176. Another approach to this problem would be to place a limitation on all trust

received by the adviser, which, for example, might arise from the adviser acting as an agent on a loan or sale, should be deducted from the adviser's fee.

(3)Approval of independent trustees for ancillary services provided by the adviser. The potential exists for most advisers to obtain a great deal of compensation in addition to that of the advisers fee. For example, commercial bank advisers can benefit from bank balances maintained by the REIT, loans made to the REIT, or transfer agent services provided to the REIT. The terms of such transactions should therefore be reviewed by the REIT's independent trustees.

(4)Promoters' compensation should be forbidden unless ratified by the independent trustees following the first shareholders' election. While it has been argued that transactions upon formation of the REIT with a promoter-adviser should not be subject to independent trustee approval,[177] because promoters' compensation[178] has traditionally provided the incentive for real estate syndication,[179] this type of transaction occurs at too critical a time to allow it to escape scrutiny. If a sponsor-adviser or other affiliate sells property to an REIT at an inflated price, or leads the REIT into a poor investment, the REIT's future is in grave doubt from the start. It would also appear that required disclosure in the initial prospectus would be insufficient because of the doubtful impact this disclosure normally has in the securities market.[180] Therefore, requiring ratification at a point in time when the shareholders, and not just the adviser or promoter, have participated in trustee selection, should provide badly-needed protection for shareholders at a time when they are not yet present to protect themselves.

(5)A duty to disclose on the part of affiliated trustees. It should be made clear by statute, as it was in section 15(c) of the Investment Company Act with regard to mutual funds,[181] that affiliated trustees are under a duty to disclose sufficient information to the indepen-

---

expenses, including the advisers fee, based on a percentage of gross or net assets. Midwest Statement, *supra* note 172, § C.

177. Midwest Statement, *supra* note 172, § B(1).

178. In return for property transferred, or services rendered to, the REIT, a promoter might accept cash, a subordinated or unsubordinated equity interest, an option on stock, or a warrant. Armstrong, *An Attorney's Viewpoint*, 48 VA. L. REV. 1082, 1090 (1962).

179. *Id.*

180. Note, *supra* note 39, at 619-20.

181. *See also* Moses v. Burgin, 445 F.2d 369 (1st Cir. 1971), which established such a duty prior to the enactment of section 15(c). For a discussion of this case and its ramifications for affiliated directors of mutual funds, see Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179 (1971).

dent trustees so as to enable them to participate effectively and in an informed manner in the management of the REIT.

C. *The Adviser's Fee*

One reason for the troubles borne by the REIT industry was the great extent to which they leveraged their shareholders' equity.[182] To a certain degree, the basis on which most advisers fees were calculated, which was a percentage of gross assets or loans committed,[183] encouraged this heavy acquisition of debt.[184]

At the very least, the adviser's fee should be calculated as a percentage of loans actually disbursed, not simply committed. To do otherwise gives the adviser too much control over when his income is recognized. Moreover, the adviser has not really earned his fee until the REIT's funds have been invested.[185]

Another approach, which has already been adopted by several REITs, is to calculate the adviser's fee as a percentage of the REIT's net income.[186] While this formula does offer the advantage of providing incentive to the adviser to invest wisely, it can also have the effect of encouraging high-yield investments that usually involve more risk.[187]

By far the best solution, however, is a formula based on several factors. Part of the fee should be based upon net income, which will provide some incentive to the adviser to invest so as to provide a steady dividend flow to the shareholders. Another portion should be determined by reference to the REIT's net assets (fair market value of loans outstanding and property owned, less the debt outstanding), which will encourage increased equity participation by the investing public. A final portion should be based, as most of the entire fee is today, on the REIT's gross assets, because the quality

182. See note 39, *supra* and accompanying text.

183. Thomas, *supra* note 41, at 2.

184. *Id.*; Robertson, *supra* note 22, at 168-69. By the end of 1973, leverage in the REIT industry was 2.5 to 1, with some REITs possessing debt to equity ratios of 7 to 1. Robertson, *supra* note 22, at 169.

185. *Real Estate Trusts Consider Lowering Fees Paid to Advisers*, Wall St. J., Apr. 26, 1973, at 32, col. 2.

186. *Connecticut General Mortgage Is Changing Basis of Advisers Fee*, Wall St. Jr., Mar. 21, 1974, at 5, col. 1.

187. Polubinski, *The Effect of State Securities or Blue Sky Law Regulation Upon the Organizational Structure and Operation of Real Estate Investment Trusts*, 30 Bus. Law. 179 (1974). The concern here is that an adviser may recommend high-yield investments solely to increase his adviser's fee and will not give adequate consideration to the risk associated with such investments.

of service and the effort expended by an adviser can be affected by the size of the portfolio.[188]

D. Diversion of Investment Opportunities

When an REIT and its investment adviser are both engaged in the same type of business, which is often the case when the adviser is a commercial bank actively entering into loan agreements, the adviser will be tempted to retain the most promising investment opportunities for itself. Not only would such actions deprive an REIT of promising opportunities, but they would also contribute to a low-quality portfolio over the long run.

To eliminate this potential for abuse, the REIT should possess a right of first refusal, to be exercised by the unaffiliated trustees, of all investments available to the investment adviser or to a trustee because of his position as such.[189] Nevertheless, because it may be impractical for certain extremely large advisers, such as Chase Manhatten Bank, to provide the necessary information, or too time-consuming for the trustees to evaluate all the possible investment opportunities, large advisers could be exempted from this requirement, so long as they agree to be fair in this regard.[190]

E. A Uniform Method of Accounting

One of the factors that directly caused much of the loss suffered by REIT investors was the lack of a uniform method of accounting.[191] Had investors known of the great number of loans that were close to default, the large percentage of REIT assets that were non-earning, or the extent to which REIT assets included foreclosed properties, they surely would not have paid the prices they did for REIT stock.[192] Indeed, they might not have invested at all.

A gallant attempt was made to achieve this goal in mid-1975, when the accounting standards division of the American Institute of Certified Public Accountants sent its recommended set of audit-

---

188. Midwest Statement § C advocates a similar formula.

189. Polubinski, *supra* note 187, at 191. Another alternative would be to allow the REIT to participate up to a certain maximum percentage in any investment by an adviser or trustee.

190. This author recognizes that the drawing of a line between banks "too large" and those not too large will be difficult. Nevertheless, the line must be drawn so that these very large institutions will not be discouraged from serving REITs with their extensive and vast knowledge.

191. See notes 75-81 *supra* and accompanying text.

192. *When Is a Lemon A Lemon?*, *supra* note 18.

ing standards for the REIT industry to the Financial Accounting Standards Board (FASB), the accounting profession's rule-making body.[193] The FASB later declined to consider those recommendations, however,[194] and no further attempts have been made to establish a uniform set of standards.

Among the specific problem areas that should be considered in establishing a uniform method of accounting are the following:

> (1) how to make the determination that a particular loan will be uncollectible, so that the accrual of interest income from the loan should cease;
>
> (2) how much should be added annually to a loan-loss reserve established to provide for future losses on loans that will become uncollectible; and
>
> (3) how to adequately disclose important information such as the number, amount, and nature of foreclosed properties, the terms of the investment adviser's fee, and the existence of compensating balances and other restrictions upon cash.[195]

F. Restrictions Upon REIT Operation

While it has been argued that one of the most devastating causes of the decline in the REIT industry—the lending and interest rate strategy used by management—may not be susceptible to effective regulation,[196] it is clear in light of the horrible failures by many REITs that an attempt should be made. Therefore, while many of the following proposals might be criticized as attempts to legislate conservative management,[197] they are offered to correct many of the common practices used by REITs that turned out to be far too aggressive or risky.

(1) A limitation on leverage. While a ceiling on the incurring of debt places a restriction on the principle of finance upon which most real estate investments are based,[198] the riskiness and potential for

193. *Proposed Auditing Standards for REITs Would Cut Sharply Profit of Some Trusts*, Wall St. J., June 27, 1975, at 19, col. 1.

194. *Accounting Panel Won't Consider Set of REIT Guidelines*, Wall St. J., Sept. 10, 1975, at 13, col. 3.

195. While it should of course be the accounting profession that should attempt to solve these problems, it may be necessary to assign this function to the SEC if the accounting profession is not forthcoming with concrete and clear standards for the area.

196. Ostema, *supra* note 43.

197. Armstrong, *supra* note 178, at 1097, where he offers that criticism of certain provisions of the Midwest Statement, *supra* note 172.

198. Wheat & Armstrong, *Regulation of Securities of Real Estate Investment Trusts*, 16 Bus. Law. 919, 932 (1961).

disaster of unlimited leverage becomes prohibitive as the debt to equity ratio increases past a certain point.[199] While it could be required that a trust's borrowing "not be unreasonable,"[200] it seems that a specific limitation on debt of 300% of shareholders' equity would ensure a substantial margin for the protection of investors, but yet still allow adequate use of the leverage principle by the REIT.[201]

(2) A limitation upon construction loans and investment in unimproved property. Because construction loans and investment in unimproved property turned out to be the most risky for REITs,[202] a limitation upon such loans and investments as a percentage of total loans outstanding would achieve the benefits of diversification.[203]

(3) A requirement that a long-term financing commitment be obtained before a construction loan is made. One reason for many defaults by construction borrowers was their failure to obtain long-term financing upon completion of the project.[204] An REIT should therefore not disburse construction loan funds unless the borrower has obtained a commitment from another source for long-term financing.

(4) Limitation of loan amount based on a percentage of the property's fair market value. Another of the reasons for the problems faced by the REIT industry was their practice of loaning more than the current fair market value of a particular piece of property.[205] When an REIT was forced to foreclose on such property, it was not able to recover its investment. Therefore, a percentage limitation comparable to that followed by commercial banks would be reasonable.[206]

(5) Restrictions upon competing mortgages. Once a borrower goes into default, the recovery by an REIT of its investment by foreclosure and subsequent resale or development can be substan-

199. Polubinski, *supra* note 187, where the author recommends a limitation on debt of 500% of shareholders' equity.

200. Midwest Statement, *supra* note 172.

201. California at the present time follows a 300% limitation. *See* Calif. Regs. § 260.140.95(e).

202. See note 71 *supra* and accompanying text.

203. *See* Godfrey & Bernstein, *supra* note 23, at 663-64; Polubinski, *supra* note 187, at 195.

204. *See* Ostema, *supra* note 43.

205. *See* Lynn, *supra* note 113.

206. If state or local law sets such a percentage, their decisions could be used, so as not to provide other financial institutions with a competitive advantage over REITs in the area.

tially delayed if the REIT's mortgage is subordinate to another. Confining an REIT's investment to first mortgages only,[207] or at least to those not subject to non-institutional lenders' mortgages,[208] would therefore be advisable.

G. *Access by REIT Investors to Judicial Redress*

In addition to providing for jurisdiction of the federal courts, and a right of action in REIT investors for alleged violation of the above regulatory provisions, substantial changes in existing law can be made so as to allow full judicial review of some of the abuses and mismanagement that have plagued the REIT industry.

(1) Standards of fiduciary duty. The inclusion of a provision similar to section 36 of the Investment Company Act[209] would greatly discourage the breach of fiduciary duty by trustees and investment advisers. That section allows the SEC to bring an action against any mutual funds adviser, trustee or principal underwriter when it is alleged that "a breach of fiduciary duty involving personal misconduct" has occurred.[210]

(2) The grant of standing to debenture holders. As was noted previously, not allowing debenture holders to bring a derivative suit effectively forecloses a wide segment of the investing public from redress for mismanagement by an REIT's investment adviser.[211] If actions taken by an investment adviser have lessened the value of a debenture holder's investment, that holder should have the right to recover just damages from the adviser.

(3) No absolute causation defense for defendants. Just because an entire industry has deteriorated, a plaintiff should not be prevented from showing that the actions taken by the REIT's trustees or adviser would have, by a preponderance of the evidence, caused a loss to the REIT investor.[212]

(4) Changes in the Investment Advisers Act. An express right of action should be granted for a violation of section 206 of the

---

207. See note 206 *supra*.

208. *See* Wheat & Armstrong, *supra* note 198, at 932.

209. 15 U.S.C. § 80a-36 (1970). *See* Note, *The Relationship Between the Investment Adviser and the Mutual Fund: Too Close for Comfort*, 45 FORDHAM L.J. 183 (1976), for a discussion of this section.

210. 15 U.S.C. § 80a-36 (1970).

211. See text accompanying notes 129-132 *supra*.

212. See text accompanying notes 133-134 *supra*. *Cf.* Escott v. Barchris Const. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968), where the court refused to consider the decline in stock of the industry of which defendant was a member.

Investment Advisers Act.[213] Moreover, included in the class possessing standing should be REIT investors, who, because of the "conduit" nature of an REIT, are the real beneficiaries of an investment adviser's services.[214]

H. The Proper Federal Administrative Agency

There exist several federal agencies that might possess the expertise and experience necessary for strict yet fair enforcement of the regulatory statute proposed by this article. For example, the Department of Housing and Urban Development has acquired a great deal of knowledge in working with the financing of real estate development, knowledge that might be put to great use in overseeing the financing strategy used by REITs. Another possible candidate would of course be the Internal Revenue Service, which should now possess great familiarity with the operation of REITs by virtue of its involvement in the tax legislation that created the industry and provided for its treatment under the tax law. Still another agency that might be given primary enforcement responsibility is the Office of the Comptroller, which possesses regulatory authority with regard to the banking industry.[215] Given the past propensity of banks to set up REITs and act as their investment advisers,[216] the Comptroller's knowledge of banking operations would be quite useful in dealing with the REIT industry.

The one drawback to the use of any of the above agencies, however, is the fact that their respective areas of expertise all relate to just one phase or another of the operation of an REIT. The Securities and Exchange Commission, however, has not only had great experience in dealing with real estate finance,[217] but also has possessed primary responsibility for the enforcement of the Investment Company and Investment Advisers Acts.[218] Some of the provisions of these Acts are quite similar to the statutory framework proposed by this article. The Commission would therefore be the most appropriate federal agency to hold primary enforcement responsibility.

---

213. See text accompanying notes 147-149 *supra*.
214. See text accompanying notes 152-156 *supra*.
215. 12 C.F.R. § 1.1 (1977).
216. See notes 88-89 *supra* and accompanying text.
217. See notes 71 and 109 *supra*.
218. Investment Company Act of 1940 § 38, 15 U.S.C. § 80a-37 (1970); Investment Advisers Act, 15 U.S.C. § 80b-11 (1970).

VI. Conclusion

While the basic concept on which the REIT industry is based, that of providing access by small investors to the benefits of large-scale real estate finance, may be a sound one, the recent history of the industry is replete with many conflicts of interest, instances of overreaching, less than full disclosure to the investing public, and lending strategies that were too aggressive for the good of investors.

Because existing law has not been adequate to protect the interests of REIT investors, there obviously is a need for a new regulatory framework composed specially for the REIT industry. While the proposals to that end made by this article are not intended to provide the entire solution to the many problems faced by the REIT industry, they should certainly serve as a starting point for comprehensive discussion of the substance required for future legislation. If Congress in not enacting regulation in 1960 along with the tax legislation that created REITs was adopting a "wait and see" attitude in dealing with potential abuses of public investors, the wait should be ended—we have seen the abuses.

[From Business America, April 21, 1980]

EXPANDING THE ROLE OF EXPORT TRADING COMPANIES

National interest in expanding the role of American export trading companies as an important vehicle of export policy has now entered a more serious phase. Legislation has been introduced in Congress to provide greater federal government support for these specialized companies, and the Carter Administration has now officially endorsed the concept. Contributing Editor Richard Barovick analyzes this emerging export policy in the following article.

The idea of greater reliance on trading companies as a means of promoting U.S. exports is not new. However, the pressing need to narrow the nation's trade deficit and the increasing realization that thousands of American manufacturers are not selling abroad despite their ability to turn out internationally competitive products have combined to make it far more persuasive.

As Secretary of Commerce Philip M. Klutznick pointed out in recent Congressional testimony, the United States, unlike many of its major trading partners, does not yet have large export trading organizations, aside from the major international grain companies. While some 700 to 800 export management companies operate throughout the country, these firms are mostly quite small, typically lacking the resources to offer a full range of export services to small and medium-sized manufacturers.

Broadening the base of American exporters means devising ways for more small and medium-sized businesses to acquire the necessary know-how and financial resources to sell abroad. Trading companies would provide a "one stop" facility offering market analysis, distribution services, documentation, transportation, financing and after-sale services. In addition, the trading companies help to limit the capital outlays and financial risks that an individual company has to assume to launch an exporting effort.

Stevenson, Danforth bills.

The major legislative thrust in Congress thus far is a bill (S. 2379) introduced by Sen. Adlai Stevenson (Dem.-Ill.) that is designed to establish export trading companies as a new entity under U.S. law. A second bill (S. 864), introduced by Sen. John Danforth (Rep.-Mo.), would clarify the application of U.S. antitrust laws to export activities. While the latter is focused on the Webb-Pomerene Export Trade Act, which permits companies to engage in joint export operations, it is designed to help resolve whatever antitrust problems might arise for export trading companies. Sen. Stevenson believes S. 864 must be enacted if S. 2379 is to be effective. The two proposals are thus viewed as a package of companion efforts.

The Stevenson bill would accomplish five major tasks.

Encourage U.S. commercial banks to participate directly in a broader range of export trade services by authorizing limited investment in trading companies. A precedent for such a role is found among foreign banks, many of which own trading companies. A U.S. banking organization would thus be able to invest in or even combine the operations of many different types of firms providing export services.

This new role for U.S. banks would provide additional capital resources for trading companies as well as bring to them the extensive international experience of many banks. Specific regulations would have to be adopted by federal bank regulatory authorities to guide banks' performance.

Authorize the Export-Import Bank to provide financial services to export trading companies for a period of five years and with a commitment ceiling of $100 million. Behind this support would be the objective of providing start-up costs for new ventures or significant expansion for existing firms. Support would be provided at commercial interest rates.

Eximbank would also be empowered to guarantee commercial loans to export trading companies that are secured by export accounts receivable and inventories of exportable goods. As U.S. banks acquire experience and confidence with loans secured by export receivables and inventory, the Eximbank role would be phased out.

Authorize state and local authorities to form or participate in trading companies.

Establish eligibility for Domestic International Sales Corporation (DISC) tax benefits for "export trade services" as well as the export of "services produced in the United States," and amended Subchapter S of the Internal Revenue Code to make it more attractive to export companies.

Give export trading companies the same antitrust exemption provided under the Webb-Pomerene Act to associations engaged exclusively in export trade.

Administration position.

The Carter Administration has now formally supported many of the proposals in the Stevenson and Danforth bills. In testimony before the International Finance Subcommittee of the Senate Banking Committee, Secretary Klutznick said that the Stevenson and Danforth proposals "contain the necessary elements to promote exporting by companies that do not now export, including small and minority business." Klutznick then offered specific comments on four aspects of the Stevenson bill, and proposed working with the Senate panel in further refining the measure.

Bank Participation.

Secretary Klutznick said the Administration supports the idea of permitting bank ownership of trading company operations. However, he noted, this would require a change in the long-standing policy of separating banking from other commercial activities. Therefore the integrity of financial institutions will have to be safeguarded through broad oversight functions provided by regulatory agencies.

More specifically, the Secretary recommended that a bank's initial investment in a trading company would be subject to prior notification and approval by the bank regulatory agencies, which would work with the Subcommittee to establish clear standards for acceptable investments. Significant new lines of activity or a substantial increase in investment by the parent bank organization would require further approval, and regulatory authorities should have broad discretion to limit a banking organization's financial exposure to a trading company.

Eximbank role.

The Administration fully endorsed the basic principle that Eximbank support be available to the trading companies. Klutznick did, however, note some serious reservations about financing and guarantees for start-up costs and operating expenses, and guarantees for export inventories. These activities, he said, would dilute the Bank's mission and require its involvement in domestic credit operations, where it has no expertise.

For these reasons the Administration proposed to explore more fully existing authorities such as those provided in the Economic Development Administration and the Small Business Administration statutes to determine where the authority for these functions should be lodged. The private credit market already has adeqate funds for financing inventories without federal participation, Secretary Klutznick remarked, and therefore he recommended that the provision for guarantees for inventories be deleted.

The proposed guarantees for loans based on export accounts receivable, on the other hand, "appear acceptable but need to be clarified," the Secretary remarked. This provision is similar to the Foreign Credit Insurance association programs. However, he added, there should be some provision included to assure that this financing is made available primarily to smaller, less creditworthy borrowers; not to large, well-established exporters.

Tax issues.

The Administration concluded that many, if not all, exporting trading companies should be able to meet the requirements of present DISC legislation and benefit from DISC tax deferral status. Therefore, modification of banking laws to permit bank ownership of export companies will effectively expand DISC coverage without requiring any change in the DISC statute itself.

The Administration decided that to amend DISC legislation to cover exports of all services, as well as services provided by other U.S. firms to export trading companies, as S. 2379 would do, would definitely alter the nature and scope of the DISC program and substantially increase its revenue costs. "The present realities of the budget situation do not permit such an extension at this time," Klutznick said. I could "also raise questions about our international obligations in this area and our concerns for tax equity," he added.

A wide variety of export services would qualify for DISC treatment and these tax benefits are substantial and "in our view will provide meaningful stimulus to the formation of bank-owned trading companies," the Secretary noted.

The Stevenson bill also calls for modifications in Subchapter S for export companies. First, it would allow a trading company to qualify even though it had more than 15 shareholders (the present limit permitted under the law). The Administration decided this present restriction seems reasonable and is not likely to hamper significantly the development of trading companies. Therefore it is opposed to this amendment.

Secondly, the bill proposes a relaxation in the current restriction that a Subchapter S corporation derive at least 80 percent of its gross receipts from the United States.

The Administration has generally supported a proposal by the Joint Committee on Taxation to overhaul Subchapter S, which would include elimination of the 80 percent restriction. Because few trading companies are likely to be owned by individuals, it was noted, this provision is not a critical element of support.

The Administration also voiced opposition to the concept of state ownership of trading companies. "State ownership is not necessary and could pose possible problems of favoritism, as well as questions on immunity from antitrust laws and taxation by the federal government," the Secretary states.

Antitrust exemption.

Klutznick said the Administration recognizes that the need of business is for assurance that specified cooperative export activities will not subject companies to antitrust liability. "The Administration sympathizes with this need," he said. At the same time, he added, "we do not want to create an antitrust exemption that may have anticompetitive effects in the United States."

The Administration position, therefore, is that the best approach is to amend the Webb-Pomerene Act to provide a flexible procedure for certifying the planned activities of American businesses that want to engage in exporting activities that might be perceived to raise antitrust problems. Under the procedure the Administration foresees, one or more companies would present to the Department of Commerce a reasonably detailed statement of what export activities are planned.

Applicants for approval could include manufacturers, construction companies, or firms selling other services. An applicant could include an enterprise that planned to coordinate the export efforts of others with marketing, financing, and other assistance, and that would buy the merchandise of these companies for export. Certification would be determined on the basis of statutory standards by the Commerce Department, with the participation of the Attorney General.

Joint activities would be certified only if they would help promote export trade and would not likely result in a substantial lessening of competition in U.S. commerce One possible adjustment of the law would be to place limits on the number or kind of new members or customers that could be added before the applicant would have to file for an amended certification.

Under this procedure, once certification was granted the export organization would be exempted from antitrust liability for the activities described in the certification. The Commerce Department could revoke the certification if the organization's activities ceased to conform to statutory standards. The Attorney General and the Federal Trade Commission would be empowered to seek decertification through administrative and/or court proceedings on their own initiative.

"Extension of the Webb-Pomerene exemption to specifically covered services," as contemplated in the Stevenson and Danforth bills, "will allow construction companies, consultants, export companies, and other providers of services to contribute to our national effort to increase exports," Secretary Klutznick noted.

O